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IN THIS ISSUE

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"To cultivate, promote and disseminate knowledge and information concerning accountancy and subjects related thereto; to establish and maintain high standards of integrity, honor and character among certified public accountants; to furnish information regarding accountancy and the practice and methods thereof to its members, and to other persons interested therein, and to the general public, to protect the interests of its members and of the general public with respect to the practice of accountancy; to promote reforms in the law; to provide lectures, and to cause the publication of articles, relating to accountancy and the practice and methods thereof; to correspond and hold relations with other organizations of accountants, both within and without the United States of America; to establish and maintain a library, and reading rooms, meeting rooms and social rooms for the use of its members; to promote social intercourse among its own members and between its own members and the members of other organizations of accountants and other persons interested in accountancy or related subjects, and to do any and all things which shall be lawful and appropriate in furtherance of any of the purposes hereinbefore expressed."

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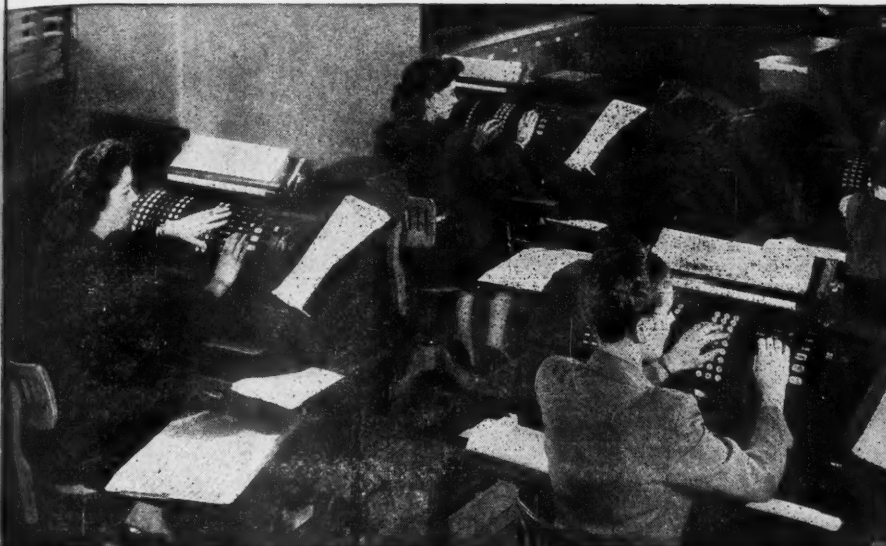

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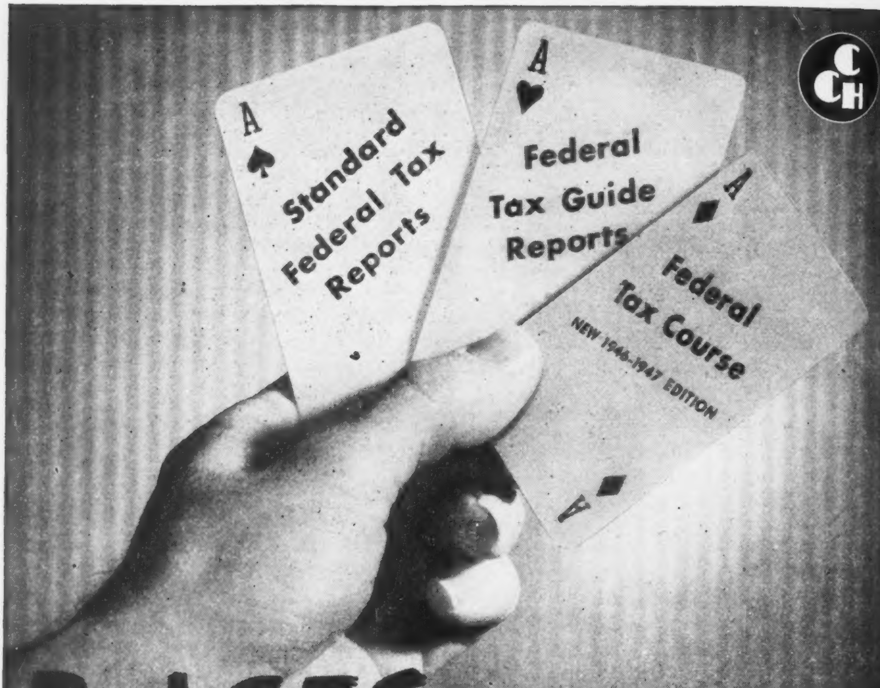

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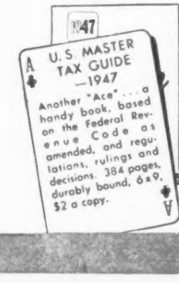

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THE NEW YORK CERTIFIED PUBLIC ACCOUNTANT

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Statements of Accounting Policies

By JOHN W. CLARKE, C.P.A.

INTRODUCTION

A COMPREHENSIVE, concise and connected statement of accounting policies is a vital prerequisite to the successful management of complicated financial activities and to the conduct of an adequate audit.

Webster defines policies as courses of procedure or conduct. Following this definition, accounting policies are considered to consist of a series of basic standards which guide the conduct of financial activities. They are distinct from accounting procedures, which are the methods used in placing the policies into effect; and separate from auditing, which is primarily concerned with the function of examination.

The subject of statements of accounting policies appears to be a new one, as one may read little thereon in accounting literature. One may find much information concerning various points of accounting policies, such as inventory pricing, surplus charges, and establishment of reserves; and on several occasions a few points of policy have been assembled and labelled "basic principles". However, comparatively little discussion exists in which a completely assembled accounting program is the principal subject. In this article, attention is drawn to the need for a statement of accounting policies.

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This article endeavors to show that an entirely different approach to the subject of accounting policies is necessary before any worthwhile contributions can be made to the vital subject of statements of accounting policies. Existing published studies relating to "basic principles", although of much value, appear to be mere theoretical concepts, inasmuch as they are not tailored to fit the needs of a particular organization.

The tendency in accounting study is strongly toward the subjective as the dominant method. It has become the exclusive method, because the subject is usually limited to considerations involving the individual elements to the exclusion of the whole. Views relating to elements, from a subjective perspective, can lead to grave and ever increasing errors which may be observed quite easily when an objective approach is made. We may stand at the center of a city or a landscape and secure, to some degree, the results of observations we are seeking, but, at best, they will be approximate, limited and local.

Let us consider a number of requisites of a statement of accounting

policies by means of a homely analogy which may illustrate, from several viewpoints, a comparison which could be made between a statement of accounting policies and an automobile. A study of their composition would indicate that both consist of a number of parts requiring an assembly process before they can function as a completed whole. Although the parts are of various proportions, experience and study would confirm an opinion that all are as necessary and compact as convenience would require; a few parts may be withdrawn temporarily when they need overhauling and repair; many require constant attention as they are used; and economy of operation is gained by the continued research directed to the elimination of all superfluities. If we extend our analogy to the finished products, other observations may be made—we see them as workable units; may inspect their appearance; their performance under different conditions may be appraised; usefulness for various purposes may be considered; and, finally, one can use them to the best advantage.

During the recent war a number of statements of accounting policies, outlined as formal agreements, were approved by boards of directors and company officers. Some of the statements contained certificates of executive accounting officers to the effect that the data were fairly presented. When directors and others, entrusted with the obligation of acting honestly and impartially for absent owners, realize that their financial policies may be scrutinized by interested parties, including the Government, other legal bodies, creditors, stockholders, veterans, internal auditors and other employees, as well as by public accountants and trade unions, the policies are apt to receive the benefits of most careful attention.

Accountants, are, as a result of their intimate relationship with the whole range of industrial, trading and financial undertakings, in a preeminent position to make an authoritative contribution towards the preparation and wise use of statements of accounting policies.

In the first part of this article, the need for statements of accounting policies is stressed from observations concerning:

1. Value to management.
2. Recent financial disclosures.
3. The American Institute of Accountants:
   Rule 5.
   The public accountant's certificate.
4. Current audit practices.

The second part of the article is concerned with the preparation and content of statements of accounting policies.

THE NEED FOR STATEMENTS OF ACCOUNTING POLICIES

Value to Management

During the formulation of statements of accounting policies, accounting procedures are reviewed in order to ascertain if the policies are properly implemented. This practice causes obscure and inconsistent phases of activity to be brought to light.

When activities are widely dispersed, such as in subsidiary companies located in different areas, the presence of a policy statement caused a lesser amount of deviation from headquarter's ideas, and a smaller probability of mistakes arising from wrong decisions and different interpretations which may occur by not thinking through the problems involved.

Executives can devote more attention to performance when they are relieved of the recurring mental gyrations which are always present when policy statements do not exist.

Authority may be delegated more easily and employees may be trained more quickly when lines are closely defined to indicate the courses to pursue.

In addition to a clear presentation of various particulars contained in the initial statement of accounting policies, studies of tested policy performance of other companies may be originated. For example, if it is discovered that an organization does not possess a good budget plan, has an archaic cost system

or poor selling pricing policies, it would be logical to direct attention to improvements which may be secured by the substitution of sound alternative policies.

Management's need for a statement of accounting policies is discussed in following paragraphs of this article under captions where other important advantages of a direct and indirect nature may be more easily explained.

Recent Financial Disclosures

An illustration of a bad situation which existed when a statement of accounting policies was absent concerns audits of the Reconstruction Finance Corporation and its subsidiaries by the Corporation Audits Division of the General Accounting Office (GAO). Particulars of these audits are given in The New York Times of June 22 and July 5, 1946. It appears that under the law authorizing the GAO to audit the affairs of all Government corporations, which was passed in February, 1945, the GAO was ordered to make an audit report to Congress by January 15, 1946.

The following remarks are attributed to the General Accounting Office:

> "Indeed, it has been found that a satisfactory audit cannot be made and that no certification may be given of the financial statements of the companies at the close of June 1945. * * *.
>
> "Some of the most important accounting records are so poorly devised, and some of the accounting practices so poorly conceived, that it is doubtful, from a management standpoint, if any really useful purpose is served by their continued maintenance in the form and under the methods now in use. * * * Nor do these records afford an adequate basis for a satisfactory report of the discharge of important operating and fiscal responsibilities assumed by the companies or a satisfactory report of the discharge of the aggregate responsibility of the top management for any period."

As specific examples of the failure of the accounting function in RFC, the report states that the company does not control: its $7,000,000,000 investment in properties; its $800,000,000 investment in inventories of Defense Supplies Corporation, Metals Reserve Company and U. S. Commercial Company; its cash receipts; rentals earned on its properties; certain important liabilities; recoveries due it on plant extensions built for utility companies; its surplus property disposal activities; and activities of its affiliate, the U. S. Commercial Company.

In the July 5, 1945, edition of The New York Times, Jesse H. Jones, former chairman of the Reconstruction Finance Corporation was reported to have called the audit report above referred to "a calculated attempt to damage the agency", and to have stated that between 1932 and 1941, the RFC was audited by prominent public accounting firms, in addition to its own "running audit" and "during this period more than $15,000,000,000 was authorized by the RFC and no semblance of irregularities was disclosed by auditors and no criticism has been made other than the fact that the Corporation did a good job".

Under present accounting practices, statements of accounting policies are not considered as entities in auditing and accounting text books and by accountants in general. The omission of this subject causes costly delays in presenting audit reports, as indicated above. Management may be criticized by shareholders and others for actions occurring over long periods of time; and public accountants may be blamed for the neglect of management to provide statements of accounting policies. Failure by public accountants to draw attention to weak accounting policies, which could not be known to them without much impractical detailed auditing, might be avoided if a statement of accounting policies existed, because concentration could be applied selectively to those items indicated to be weak.

Also under the present practice (where accountants are trained to give attention to the parts to the exclusion of the whole), because weaknesses in policies were not readily apparent, serious defalcations, financial abuses and

harm to many people may exist and not be located until the damage is irreparable.

The world has been appalled on several occasions by the results of actions of men such as Kreuger, the match king, and the objectionable financial practices such as were described in Justice Ferdinand Pecora's investigation of Wall Street. We are being shocked daily by news of the results of Senate and other investigations of the war-time malpractices of a number of companies.

The American Institute of Accountants

Rule 5.

The absence of a firm basis or guide causes particular difficulty to public accountants in living up to the rules of professional conduct of the American Institute of Accountants. The most important rule might be Rule 5, which relates to false and misleading statements. This rule was amplified in 1941 and now reads as follows:

> "In expressing an opinion on representations in financial statements which he has examined, a member or an associate shall be held guilty of an act discreditable to the profession if:
>
> (a) He fails to disclose a material fact known to him which is not disclosed in the financial statements but disclosure of which is necessary to make the financial statements not misleading; or
>
> (b) He fails to report any material misstatement known to him to appear in the financial statement; or
>
> (c) He is grossly negligent in the conduct of his examination or in making his report thereon; or
>
> (d) He fails to acquire sufficient information to warrant expression of an opinion, or his exceptions are sufficiently material to negative the expression of an opinion; or
>
> (e) He fails to direct attention to any material departure from generally accepted accounting principles or to disclose any material omission of generally accepted auditing procedure applicable in the circumstances".

John L. Carey, Secretary of the American Institute of Accountants, in his book "Professional Ethics of Public Accounting", states in reference to Rule 5, "The most effective reinforcement of an accountant's independence is the requirement that he tell the truth without fear or favor".

An unnecessary amount of detailed auditing and an inadequate audit can result from the absence of a solid foundation to support comments relating to accounting policies; while the presence of statements of accounting policies permits of easier, wider and more concentrated tests of policy performance, all tending to strengthen the audit procedure.

The public accountant's certificate

The importance of accounting policies is recognized in auditing. Thus, in addition to the representations as to the scope of the audit, the public accountant's certificate is required to state clearly, the opinion of the accountant in respect of the financial statements covered by the certificate and the accounting principles and practices reflected therein. An opinion is also required concerning significant changes in accounting principles and practices; and matters to which the accountant takes exception should be specifically and clearly stated.

The above sentiments are expressed in Bulletin No. 22—Statements on Auditing Procedure, dated May, 1945. The writer perused a large quantity of accounting literature for the purpose of finding an official statement of opinion of the majority of leading members of the American Institute of Accountants regarding the prime responsibility for preparing statements of accounting policies.

Bulletin No. 22 also states that the public accountant is not primarily responsible for such statements as are covered by his opinion, because the transactions with which the accounting records are concerned, and the recording of those transactions in the books and accounts, are matters within the direct knowledge of the company; the accountant's knowledge is a secondary one, based on his examination.

In other words, the substance of the financial statements is considered to be the statements and representations of the company and the company is primarily responsible for preparing statements relating to accounting policies.

Current Audit Practices

In an editorial in the June, 1946, edition of the Journal of Accountancy, the statement is made that "auditing is the principal work of a great number of accountants both in public practice and private employ". One may conclude from this, that anything which would tend to minimize the auditing detail would be of substantial value, on account of the large number of accountants and vast detail involved.

The absence of complete statements of accounting policies in a readable form causes accountants to proceed in their auditing work without a guide, and consequently with difficulty, because, in order to be able to substantiate opinions to stockholders and others, supporting evidence must first be constructed. The difficulty is augmented when the audit function is performed during the so-called busy season, represented by the early months of the year, when the time element in which the work is to be completed is of great importance.

The obligation resting upon companies to prepare statements of accounting policies for audit guidance and other purposes, seems to have been given little publicity by the accounting profession. A few leading accountants have advocated the preparation of statements of accounting policies, but the extent of their advocacy seems to have been confined to recommendations contained in articles devoted to other subjects. One may find abundant evidence in the offices of public accountants of efforts made to construct information concerning particulars of individual points of accounting policies. How often does one see a certificate of a public accountant in which attention is drawn to the absence of a company prepared, comprehensively written, statement of accounting policies?

During the audit, three distinct activities are conducted:

1. The verification of accounting records and transactions essential to support the financial statements to be presented.
2. A study of available accounting policy evidence, to determine whether or not the records of a past period fairly and consistently reflect policies decided upon.
3. Tests of accounting procedures explanatory of methods installed to place the policies into effect and to control accounting records and transactions. This is commonly known as a review of the system of internal control.

Evidence concerning accounting policies is often located in a number of files and commingled with other things, such as—financial survey data; working papers containing analyses of accounts; particulars of internal accounting control; accounting procedure details; permanent historical files; and in various memoranda. Succeeding audits frequently disclose policy information which was not discovered during the previous audits. Such a dispersal of information can only result in the wasting of time in searching for accurate policy data. And when the need arises to consult the audit evidence of a previous year, located in other sets of audit papers, an additional waste of time is incurred.

If one had a comprehensive, concise statement of accounting policies before the commencement of an audit, time

now consumed in searching for policy information among vast detail would be saved. Also, one would be able to place greater reliance on carefully prepared data than on the inadequate substitute, prepared hurriedly, which is frequently to be found scribbled on working papers, and sometimes contained in obscure parts of lengthy texts of accounting procedure explanations.

THE PREPARATION AND CONTENT OF STATEMENTS OF ACCOUNTING POLICIES

The ideal statement of accounting policies would be based on equilibrium and order, on justice, trust and reciprocal confidence.

An imposing list of individuals and agencies who may scrutinize statements of accounting policies is mentioned in the introduction to this article. When consideration is given to the fact that publicity is a great corrective measure, and policies might also be reviewed by the public, by means of newspapers, it is easy to assume that the tendency in the preparation of statements of accounting policies is to exclude humbug and nonsense.

Careful attention to the preparation and use of statements of accounting policies could result in the elimination of financial practices which are obscure, unfair, incorrect, inconsistent or illegal, or in reductions in the areas in which they formerly occurred. When the area of uncertainty is reduced, concentration may be more easily placed on remaining weaknesses.

In order that full advantage may be obtained from the study of alternative policies, the writer is of the opinion that statements of accounting policies should be tailored to fit the needs of the various industry groups. Such groups would include the manufacturing industry and the forty-two non-manufacturing industry groups, the principal of which, according to the Securities and Exchange Commission, are: retail trade, wholesale trade, mining, transportation and communication, service, construction, agriculture, finance and real estate.

In this article the discussion concerns only the method of preparation and content of statements of accounting policies applicable to the manufacturing industry. However, many points of policy mentioned are common to different industry groups and the need for policy guidance appears to be common to all groups. Members of non-manufacturing groups may benefit from a study of the form and general arrangement of policy statements applicable to the manufacturing industry.

The information given in the balance of this article concerns statements of accounting policies which were prepared during the war as a result of the provisions of the Contract Settlement Act of July, 1944. The data may be helpful to a reader not familiar with the terms of the Act because:

1. Accounting literature does not contain any policy statement as authoritative concerning a particular industry.
2. The points of policy are not radical according to the usual connotation of that word. They have been used as the basis of formal agreements between major war contractors and the Government. A huge part of the dollar volume of all contracts of the War and Navy Departments were settled on the basis of these policy points by the Eastern Audit District of the Army Air Force.
3. The points of policy mentioned were considered as reasonable by contractors, inasmuch as:
   (a) Accounting literature is available concerning each of the points mentioned, and
   (b) No criticism of the content was made to the Eastern District Audit District of the Army Air Force.

Incidentally, most of the points of policy mentioned in this article are not stated in the Contract Settlement Act. The points mentioned in the Act were placed there to give an indication of

their general nature. The Act provides that policies shall be reasonable and that an appraisal shall be made of their content. As several of the largest corporations in the country were involved in settlements within the scope of the Eastern Audit District of the Army Air Force it was necessary to augment the provisions of section 50 of the Joint Termination Accounting Manual containing the suggestions entitled "Contractor's Accounting Policies".

Preparation of Statements of Accounting Policies

The Contract Settlement Act includes a questionnaire, entitled "Contractor's Accounting Policies", in paragraph 50 of the Joint Termination Manual, which is applicable to War and Navy Department contracts.

The purpose of the questionnaire was to ascertain, in advance of mass contract terminations, the war-time and peace-time accounting policies of certain selected contractors having large war contracts; and the extent of deviation during war-time from peace-time policies. The results of the questionnaire, and more frequently a combination of the questions and answers in concise form, constituted what was known as a statement of accounting policies.

The information required was broad in its scope, as a number of companies were asked questions concerning each of the following subjects:

> Policies concerning inventories—pricing, accounting controls and extent of complete physical inventories; material costs; direct labor costs; indirect manufacturing expenses; fixed assets and depreciation; perishable tools and manufacturing supplies; tooling costs and special facilities; spoiled work and scrap; standard costs and related variances; separation pay; labor premiums and bonuses; pension, group insurance and profit sharing plans; repairs and maintenance; engineering, development and starting load costs; general and administrative expense, including method and basis for proration to contracts; prepaid expenses and deferred charges; pricing and profit inclusion in intra-company transactions and in transactions among affiliated companies; consistency—extent of deviation from peace-time accounting policies; other income and credits; policies with respect to the establishment of reserves and their treatment in the accounts; extent of budgetary control; scope and frequency of internal audits; extent and nature of work subcontracted to others; as well as a number of items included under the heading of termination policies and applicable only to war contract terminations.

Prior to the preparation of the statements of accounting policies, surveys, guided by a survey questionnaire, were made by a large force of Government accountants who were assisted by other accountants in the employ of the contractors. The surveys consisted of an examination of accounting and other records, accounting procedures, vouchers, agreements, particulars of internal control and various documents; all necessary because most contractors did not have readily available evidence to support the policies they were to pursue in contract termination.

The survey contained the same questions appearnig in the Act relating to accounting policies; however, survey questions were started with such words as—obtain, explain, ascertain, determine, review and describe. Working papers were prepared in support of each of the items listed in the survey questionnaire. As spaces were left in the survey questionnaire for concise answers and for index numbers relating to individual supporting papers, the task of assembling policies was facilitated, and the statement, when completed, could readily be reviewed by reference to the survey supporting information.

During the preparation of the surveys a number of policies were eliminated when found to be in error and/or conflicting with other policies. It was found necessary to inaugurate some policies which were indispensible for the protection of the mutual interests of the contractors and the Government. In instances where separate statements of accounting policies were prepared by

subsidiaries, many points of policy were found to have been interpreted differently within the same companies, often to the detriment of the organizations as a whole.

Vast savings were made because the necessity for searching for supporting policy evidence was avoided when individual contracts were being terminated. One statement of accounting policies was used to govern the terminations of all contracts of a particular company and considered as a *formal agreement* between the contractor and the Government to be used by all branches of the services. Continued discussions and conferences relating to the same subjects affecting each contract were unnecessary as decisions were already matters of record.

Detailed auditing was eliminated, as selective tests conducted during the surveys were considered to be sufficiently comprehensive to determine the reliability of supporting accounts, records and procedures. In lieu of selective auditing tests concerning each claim, reliance was placed on reviews of claims in Government offices, known as office reviews, rather than on field audits.

Further information concerning statements of accounting policies, including the method of processing them by the Eastern Audit District of the Army Air Force, is given in an article by the writer in the January, 1946, issue of The Accounting Review. That article contains the suggested outline of accounting matters mentioned below, and the comment that particulars of individual procedures are omitted from a statement of accounting policies, except to the extent that an over-all policy may need amplification when varying circumstances surround a point of policy.

Content of Statements of Accounting Policies

It was suggested to regional and other staffs of the Army Air Force that requests addressed to contractors by these staffs be drawn up to embody the points in the numerical sequence of the outline given below, and to the extent practicable. Also, that the suggestions should not be construed either as limiting the points to be covered or as minimum requirements.

The writer realizes that some of the points included in the outline may be obsolete because they relate only to war contract terminations. However, such points may still be valuable as they are indicative of a method adopted to ascertain circumstances surrounding a particular situation.

The information following shows that under war contract termination procedures the emphasis is placed on the treatment of transactions affecting inventory valuations. Stress is placed on costs of manufacture, operating expenses and accounting controls. Also, wide amplification was made of the previous scope of accounting surveys.

ACCOUNTING POLICIES

(A Suggested Outline of Accounting Matters to be Incorporated into a Contractor's Statement of General and Termination Accounting Policies.)*

1. Inventory Policies:
   a. Current method of pricing inventories, and the length of time this method has been consistently used.
   b. Whether separate accounting controls are maintained over raw materials, work in process, finished goods and other inventories, including list of classifications.
   c. Whether perpetual inventory records are maintained and on what basis.
   d. Frequency of complete physical inventories and rotary or cycle checks, and the extent of the adjustment necessary to reconcile the last complete physical inventory with the book inventory, together with the accounts charged or credited.
   e. Material Costs:
      (1) Basis of charges to raw materials and work-in-process inventories.
      (2) Basis of allocation of materials to specific parts, products, or contracts, and the procedure for handling common items.
      (3) Basis used in determining quantities to be purchased or manufactured, including method of scheduling purchases or shop orders of common items.

* By permission of The Accounting Review.

(4) Basis for inclusion of inbound transportation, material handling, and other like costs included in the inventory pricing.
(5) Treatment of purchase discounts and year-end volume rebates or discounts.
(6) Method of determining costs transferred from work in process to finished goods or cost of sales.
(7) Whether terminated inventories and excess or obsolete items are segregated.

f. Direct Labor Costs:
(1) Basis of charges to work in process, including allocation to specific parts, products, or contracts.
(2) Distinction between direct and indirect labor, indicating treatment of inspection and set-up labor.
(3) Method of determining costs transferred from work in process to finished goods or cost of sales.

2. Indirect Manufacturing Expense:
a. Classes of overhead and general description of the items in each, together with the general basis of allocation and redistributions to the direct and indirect burden centers.
b. Basis of charges to work in process, including allocation to specific parts, products, or contracts.
c. Treatment of expenses of idle facilities.
d. General policies for distinguishing between charges to fixed assets and to expense accounts.
e. Treatment of rent on Defense Plant Corporation facilities, if any.
f. Treatment of under- and over-absorbed-overhead in the accounts.
g. Nature and basis for charges for obsolescence.
h. Method of determining costs transferred from work in process to finished goods or costs of sales.

3. Other Direct Charges to Fabricating Costs, and basis for such charges.

4. Fixed Assets and Depreciation:
a. Type of property records maintained, e.g., by units, by classes, by year installed, etc.
b. Rates used for various classifications of property, plant, and equipment.
c. Whether depreciation provisions are computed on individual assets, classes of assets on a composite life basis, etc.
d. Whether depreciation provisions recorded on the books are in excess of or less than the amounts claimed for Federal income tax purposes.
e. Whether depreciation provisions are based on accelerated rates and basis upon which such accelerated depreciation is computed.
f. Whether amortization in excess of normal rates of property acquired under Certificates of Necessity is segregated in the accounts.
g. Treatment of fully depreciated property and idle facilities.
h. Basis of amortization of leasehold costs and improvements to leased property.
i. Treatment of profit and loss on disposal of fixed assets.

5. Perishable Tools and Manufacturing Supplies:
a. Policies for their inclusion in overhead or treatment as direct charges.
b. Manner in which handled in the accounts.
c. Whether charges are made as purchased, or as actually used.

6. Tooling Costs and Special Facilities:
a. Treatment of special tooling and special facilities, basis of amortization, and accounts charged.
b. Basis for determining what tools are special.

7. Spoiled Work and Scrap:
a. Treatment of costs of work spoiled in production, including corrective or rework labor.
b. Treatment of proceeds from scrap scales or recoveries.

8. Standard Costs and Related Variances:
a. Types of standard costs used and manner in which developed, including frequency at which adjustments are made.
b. Types of variances recognized in the accounts and treatment thereof.
c. Handling of standard costs and variances therefrom on transfers from work in process to finished goods or cost of sales.

9. Separation Pay:
a. Policies with respect to separation pay.
b. Manner in which handled in the accounts.

10. Labor Premiums and Bonuses:
a. Policies with respect to, and treatment in the accounts of, overtime and night shift premiums, vacation, idle and training time.
b. Nature of incentive bonuses and their treatment in the accounts.

11. Pension, Group Insurance, and Profit-sharing Plans:
a. Policy with regard to and nature of employee pension, group insurance and profit sharing plans, if any.

b. Whether such plans have been accepted by the Bureau of Internal Revenue.

c. Manner in which the costs of such plans are handled in the accounts.

12. Repairs and Maintenance:
General policies for distinguishing between charges to property, plant and equipment accounts (including reserves for depreciation applicable thereto), and repairs and maintenance.

13. Engineering and Development and Starting Load Costs:
Manner of recording such costs in the accounts, indicating whether they are segregated by individual projects or prorated, including the basis for such segregation or proration.

14. General and Administrative Expense:
    a. Accounts so classified and general description of the items in each.
    b. Whether items coming within the category of "excluded costs" in accordance with the Statement of Cost Principles are excluded.
    c. General nature of selling expenses, including applicability to government contracts.
    d. Nature of incentive compensation to officers and principal employees.
    e. Method of prorating general and administive expenses and basis for proration.

15. Prepaid Expenses and Deferred Charges:
    a. Types of expenses ordinarily carried in prepaid expenses and deferred charges, basis of write-off, and accounts charged.
    b. Nature of experimental, development, and research work, whether charged to specific projects, extent to which applicable to government contracts, manner of recording in accounts.

16. Intra-Company Transactions and Transactions with Affiliated Companies:
    a. Policies as to the pricing of intracompany transactions and transactions among affiliated companies.
    b. Extent to which any profit resulting from such tranactions is not excluded from costs.

17. Consistency:
Extent of significant deviations from accounting policies during peacetime period in so far as settlement proposals are affected.

18. Other Income and Credits:
Types of miscellaneous income and other credits and their treatment in the accounts, including applicability to government contracts.

19. Miscellaneous:
    a. Extent to which the detailed cost records are controlled and in agreement with the general books of account.
    b. Extent of budgetary control.
    c. Scope and frequency of internal audit.
    d. Policy with respect to the closing out of costs applicable to previously terminated contracts.
    e. Treatment in accounts of collections covering charges due to change orders and closing out of costs related thereto.
    f. Policies with respect to the establishment of reserves, and their treatment in the accounts.
    g. Whether accruals and the accounts payable are set up so that expenses are recorded in the accounting period to which they apply, including extent of year-end adjustments.
    h. Policy with regard to surplus adjustments and handling of prior-period adjustments.
    i. Nature of Defense Plant Corporation rental, if any.
    j. Extent of use of government guaranteed loans or advance funds in financing government contracts.
    k. Extent and nature of work subcontracted to others.
    l. Nature of interest expense and other deductions, and applicability to government contracts.

Conclusion

When accounting policy statements are formulated for the various groups mentioned in this article, they may be applied to financial accounting, cost accounting, internal auditing and budgetary control. And national standards of principle could be established by reference to which income statements and balance sheets should be constructed.

After considering the implications of factors mentioned in this article, and observing the benefits which were derived from statements of accounting policies during war-time, I have concluded that a comprehensive, concise and connected statement of accounting policies is a vital prerequisite to the successful management of complicated activities and to the conduct of an adequate audit.

Ten Current Tax Problems

By A Panel of Ten Leading Tax Practitioners

The following is a transcript of the technical proceedings of the monthly meeting of the Society held on Monday, November 18, 1946, at the Waldorf-Astoria Hotel. Our Committee on Federal Taxation, under the chairmanship of Mr. J. K. Lasser, arranged a most interesting program in which a panel of ten of the leading tax practitioners in New York (five certified public accountants and five lawyers) discussed some of the difficult tax problems presently confronting tax advisers.

The guest speakers, in the order of their participation in the discussion, and the subjects presented by them are as follows:

J. K. Lasser	—Chairman, Committee on Federal Taxation, and Moderator of the discussion.
George E. Cleary	—How to avoid double tax in the sale of all of the assets of a company.
Benjamin Harrow	—What are we going to do about the partnership problems that remain today?
Maurice Austin	—The trends in personal holding company matters that you ought to know about at this time.
Norris Darrell	—Some of the problems that confront us in Section 112 (g) 6 liquidations.
Thomas N. Tarleau	—The effect of sales following recapitalization.
Benjamin Grund	—What kind of increases in salaries will be approved by the Bureau and by the Tax Court?
Jacob Rabkin	—Reorganization plans involving a change in business structure in order to secure an interest deduction instead of a dividend payment.
Ewing Everett	—In what tribunal should tax cases be instituted today?
Leslie Mills	—The methods and the mechanics of disposing of partnership assets.
Mark E. Richardson	—How much should corporations pay out in dividends in November and December?

Because several hundred of our members who sought to attend this meeting were unable to gain admittance by reason of already over-crowded facilities, and by further reason of the importance of the problems discussed by the eminent guest speakers, the technical proceedings (other than the question-and-answer period) are reported herewith, in full:

Chairman Lasser: This is a meeting convened by the Committee on Federal Taxation. It is a "party" to which there have been invited, as a result of ballots cast by the Committee on Federal Taxation, five distinguished members of the bar and five distinguished accountants in tax practice.

Perhaps a word ought to be said in advance of calling upon them for their part in this evening's "show". We meet tonight following a great national election. To a great many people that suggests a change in tax rates. To some

of us it also suggests that perhaps we shall have some change in the mechanics of taxation. One is particularly struck with the need for this in many branches of taxation.

For example, fairness to small business demands simplification of Federal tax methods. Pressure of public opinion has already accomplished that for the salaried taxpayer. No longer does he fret and fritter away hours with a complicated and elaborate tax return. Now he signs the simple form his employer gives him and mails it into the Collector. Now the Collector, and not the salaried taxpayer, does the arithmetic and figures out the tax.

Hundreds of thousands of small business men have started business in 1946. Many more will get under way in 1947. They, too, ought to be freed from the vexations and complications of the present elaborate forms. They must be freed from an outmoded and cumbersome tax reporting system. In many respects the return and the rules behind it are incomprehensible to even a trained accountant. The small business man ought to be permitted to report his tax on a form as simple as the one he gives his bank or his credit grantor. Possibly he should be able to use the very same form not only because it is simple, but to avoid a multiplicity of reports and forms. In many cases the report of his accountant, upon which he relies for guidance and control of his business ought to be acceptable for tax purposes.

Another point—the small business man should be emancipated from the obligation of keeping elaborate bookkeeping records. The records he maintains for his own information and control, however simple, should be acceptable for tax purposes. Even if they consist of an orderly assembly of cash register tapes and summaries coupled with his check book, they can serve to furnish the essential information required. Any reasonable analysis of business operations should adequately serve as acceptable for a tax return. Any factual record of financial details —however homely and primitive—that is reasonably accurate should be acceptable as adequate bookkeeping.

If a formal return on a printed form is indispensable for administrative reasons it should be so simple that anyone who commands of basic English can readily make it out. The smaller economic units—where individual proprietorship, partnership or corporation —should not be compelled to use the more elaborate forms designed for large business. The little fellow should not be obliged to go to the tax specialist for professional help with his simple return. The tax structure and the tax form should be so simple that the small businessman can readily grasp it.

The instructions that accompany the tax return should be elementary yet complete. Today they are much too technical. Most important, they should tell two things—all the taxpayer needs to know to fill out the form properly and to pay the lowest possible cost. The language can be in simple style and yet attractively presented. What the advertising man and copywriter do to reach a mass audience should be emulated by the tax-instruction composers.

The little businessman, with the harassing tax complexities and worries out of his way, needs mostly to get on with his business. He ought to be able to fully devote his energies to production, growth, and service. Taxation ought not to deter full expression of his energy. It occupies too much prominence in his arrangements today.

The meeting tonight is on a practical basis. The process is something like this: I will introduce these ten distinguished gentlemen to you. Then I will call upon them to talk to you for about six or seven minutes on a subject that we and they have discussed in advance. I will hold them down to the six or seven minutes. At the end of the meeting, if time permits, we shall be delighted to take all of the questions that you can "push at us".

The first thing I ought to do is to introduce you to the men on this panel, because you may not know a great many of them. Remember again that

this is a group of accountants and attorneys invited by your Federal Tax Committee as a result of a closed ballot—invited because we (the Committee) thought that this is the group you'd like to hear discuss some of our controversial problems in tax matters.

Down at the end of the table may I introduce to you Mr. George E. Cleary? He is a member of the bar of New York, Wisconsin and Montana, formerly on the faculty of the University of Wisconsin and also the University of Montana, a member of a great many bar association committees.

Next to him is Mr. Maurice Austin. He needs no introduction to you.

The next is Mr. Benjamin Harrow, a member of our Committee. He needs no further introduction.

Next is Mr. Norris Darrell, a member of the New York bar, well known to most of you because of his considerable activities in The Practicing Law Institute and because of many treatises contributed on a great many difficult tax subjects.

Next to him is Mr. Thomas N. Tarleau, a member of the New York bar. Of course you remember him as head of the legislative group in the Treasury.

Mr. Benjamin Grund is next to Mr. Tarleau. He is also a member of our Committee.

Down at the end is Mr. Mark Richardson. You know him also as a member of our Committee.

Next to him is Mr. Leslie Mills, a member of our Committee.

Next to him is Mr. Ewing Everett, a member of the New York bar, author of our standard text on Reorganization, and a lecturer in many places. I am sure you have heard a good deal from him before.

Next to him is Mr. Jacob Rabkin, author of my favorite tax service. He has labored much in our Tax Court trials—and particularly our moot Tax Court trials.

Now starts the part of our program in which I will call upon one of our experts to talk to you. The first man I'd like to call on—and I will do this in the order in which the men have seated themselves—is Mr. George Cleary. The subject we have asked him to take is one which caused a great deal of controversy: "How to Avoid Double Tax in the Sale of all of the Assets of a Company."

George E. Cleary: Well, gentlemen, the answer to that question is seemingly very simple. All that you have to do is liquidate the company, distribute its assets in kind to the stockholders, then have the stockholders sell the assets. It is well settled by regulation and decision that the corporation realizes no gain by distributing its property in kind. The stockholder may, of course, realize a capital gain on that liqudation, but he gets a new basis for the assets and if he sells them at no higher price there is no further gain. So that, really, that is all there is to the question. But if I left at that point it would seem too simple for any real tax problem, and there has been a lot of litigation on this subject.

One of the important questions is, Who made the sale? Did the corporation make the sale, or did the stockholders make the sale—looking at substance and not merely the form?

It is pretty clear that if a bargain for the sale of the assets is actually negotiated before the liquidation is made—even though no binding contract is entered into—the sale will be attributed to the corporation. The Supreme Court so held in 1945, in the *Court Holding Company* case.

On the other hand, it seems pretty clear that if the matter is handled properly—very carefully—the assets are first distributed; then the stockholders, acting as such or through a representative appointed by them, sell the property—i.e., the sale is made by the stockholders. The Tax Court so held as recently as August of this year, in the *Acampo Distilleries* case, where they sold an inventory of wines in that way.

The difficulty is that cases usually don't fall into these clean-cut categories;

there is usually more or less negotiation before the liquidation is made; and, where the stockholders are numerous, it is difficult for them to act without appointing a representative.

There is a tendency in the decisions, where a common agent or representative is used, to hold that he is representing the corporation rather than the stockholders. In the *Acampo* case, they took care of that very carefully. The trustees were appointed by the stockholders—were not officers or directors of the company—and there were no deals pending at the date of liquidation although the corporation had had offers and had refused to sell because of the corporate tax.

So that really the thing can be done: it is possible to have a liquidation in kind in which the corporation realizes no gain, and to have a sale by the stockholders; but great care must be taken to prevent attributing the sale to the company, either because the negotiations have gone too far at the time of the liquidation or because the persons negotiating the sale are officers or directors of the company who, even though they purport to act as individuals, may be held to act on behalf of the corporation.

The situation is further complicated by the decision of the Circuit Court of Appeals for the Second Circuit in the *Fairfield Steamship Company* case, which the Supreme Court, last Monday, refused to review. The Tax Court held in that case—where a parent company sold a vessel previously owned by a subsidiary—that that was a *Court Holding Company* case: that the negotiations had gone so far before the liquidation was voted that the sale was really made by the subsidiary; there is no objection to that decision in principle, if that conclusion was supported by the facts.

The Circuit Court of Appeals apparently did not agree on that question of fact; but they nevertheless affirmed the decision because, they first said, the case did not fall in Section 112(b)(6). That was erroneous because that Section had nothing to do with the subsidiary's taxes, only the parent's. Then the Court made an addendum to its opinion, dropping that ground, but saying that the parent company was acting as trustee in liquidation for the subsidiary and, therefore, what it did was done on behalf of the subsidiary. There had been no finding to that effect by the Tax Court and there was very little evidence in the record to support that decision but, because of that decision, it is certainly going to be harder to settle this type of case and, perhaps, to win it in the event of litigation.

Chairman Lasser: Here, now, is Mr. Benjamin Harrow, answering this question: "What Are We Going to Do About the Partnership Problems that Remain Today?"

Benjamin Harrow: First we want to remind ourselves again that the *Lusthaus* and *Tower* cases, which were decided last February and determined that the family-partnership arrangement will not hold in certain circumstances, laid down certain criteria: first, whether the wife's contribution to the capital originated with her; second, whether she contributed any services herself of any significance; and third, whether she is performing or exercising any managerial control or authority.

Now the problem today, of course, is how to mitigate the effect of the disallowance of the family partnership. In the typical famliy-partnership case you have the situation where the husband carries on a business alone, which requires capital and services, and then, because of the high surtax rates, he decides to make a gift to his wife of, let's say, half the capital. He might take the cash out of the business, and give it to her. She puts it right back into the business and now shares equally in the profits. That is the typical situation. Thereafter the business is carried on just as it had been before. Under the two decisions the entire income is taxable to the husband, just the same.

It is important to bear in mind that there is no question raised as to whether you have a valid partnership under the

State law. You may still have that. That means that you have a conflict between the property rights created and the tax consequences.

The husband, of course, possesses now only a 50% interest in the property, even though he is being taxed on all of the income. If the husband wants to revert to the single proprietorship, he may not have a serious problem in most cases where the wife is willing to give him back the property; but if there has been any estrangement or for any other reason the wife demurs, there may be some difficulty—and that would be particularly true if the family partnership involves minors.

Of course the partnership might be dissolved and the wife might then invest her share in a separate business. That is a possibility. And if you have a new venture, it is unlikely, I think, that the Commissioner would attempt to follow that through and tax the husband on the income of the new venture. However, if the Commissioner should hold that the gift was incomplete—wasn't a valid gift—he might still claim that the income should be taxed on the husband. That is one possibility of what might be done with the family partnership.

Another — and probably the most popular one—would be to organize a corporation and let the wife own stock in the corporation, represented by her capital interest.

Now it so happens that the corporation has had a comparative immunity from the assertion of a tax on one taxpayer for income earned by another. I say that, even though I am aware that in special situations the Commissioner has successfully had the dividends on the wife's stock taxed to the husband; but generally I don't think there is any evidence of a policy to attack the family corporation (I'm not thinking now of a personal holding company, or anything of that sort).

Another alternative would be the continuation of the business, with the conversion of the capital account into a loan at interest. I realize that there, too, if the gift is held to be incomplete, then it is possible that the Commissioner might attempt to follow that interest on the loan and claim that that should be taxed to the husband; it is a possibility.

Another possibility would be for some of the property—wherever that is possible—to be transferred to the husband and wife as tenants by the entirety. Now under State law, where the income is divisible between the tenants, each one is taxed on half the income; and in New York, the spouses are each entitled to one-half the income. The splitting of the income under this type of arrangement has been sanctioned in at least one case involving coal mining operations, and in an earlier ruling it was applied, also, to the operation of an orange grove.

Now in my opinion, if the business or if the income is not attributed especially to personal services, it may be that the Commissioner will not attack that arrangement. In the case of real property, for example, I believe the rents would be taxable to the husband and wife legally as tenants by the entirety.

I am told I have one minute more. I shall just briefly say that you should be careful about the Statute of Limitations with respect to obtaining a refund on the wife's income. The Statute normally is three years; it is five years if the income is going to be attributed to the husband, and 25% of the husband's income has been omitted. Section 3801 would permit the wife to get a refund under those circumstances, but if you had a minor as a partner, the minor would not come in under that provision. Therefore you should in the latter case file a protective refund claim to come within the three year statute.

One other point that I want to make is with respect to gift tax implications. In the *Tower* case, the Tax Court did claim that the gift was incomplete. The Supreme Court, however, ignored that and rendered no decision as to the completeness of the gift; it disallowed the partnership on other grounds.

If there has been a ruling to the effect that the gift is incomplete and, later,

the Commissioner brings a gift tax action involving the gift itself, then this question would be *res adjudicata,* under a recent decision. It would not be possible for the Commissioner to claim an additional gift tax, for example, with respect to the valuation of the gift. As a matter of fact, the taxpayer would be entitled to a refund if a gift tax had originally been paid.

Chairman Lasser: Maurice Austin is going to talk to you about "The Trends in Personal Holding Company Matters that you Ought to Know About at this Time".

Maurice Austin: This question is brought to the fore by a ruling and a decision which has come down during the past year.

Ordinarily we think of personal holding companies as things to avoid; but, on occasion, where we find that if the corporation were not a personal holding company—it would merely be walking out of the personal holding company "frying pan" into the "fire" of Section 102—the question of choice arises. This question is particularly important, when we realize that not only does a personal holding company include an investment type of company, but also a company closely held whose income is entirely from rentals received from individuals who are its major stockholders.

The principal feature which might make the personal holding company preferable to the Section 102 tax is the 1942 legislation to the effect that, in the case of a net long-term capital gain, a personal holding company, having once paid the 25% alternative tax on Form 1120, is not again required to pay another tax on such gain under the personal holding company provisions, even if there is no distribution; whereas, in the case of a Section 102 company, after having once paid the 25% alternative tax, the company is still subject to tax on such gain under Section 102 in the event of non-distribution.

As against that, if the company is disposed to make large contributions, it finds that for the purpose of the personal holding company tax, contributions are limited to 15% of net income, whereas for the Section 102 tax, there is no limitation upon the contributions.

A rather unusual situation is brought out by the fact that, for purposes of Section 102, there is no limitation whatsoever on the deduction of capital losses. At the same time, however, the capital loss carry-over for five years is disregarded for that purpose. However, in the case of the personal holding company, the ordinary rules of deduction and taxability of capital gains and losses apply, including the five-year capital loss carry-over. Under those circumstances you can get this peculiar situation: that if a company is a Section 102 company in year 1 and has large capital losses that year, such losses are deductible in full in determining the undistributed income subject to Section 102 tax; and, if, in the next year, the corporation should become a personal holding company, the capital loss of the preceding year can be carried over against short-term gains of the following year in determining the income subject to personal holding company tax. There is, therefore, a double deduction of the same item.

Under a Bureau ruling this year, the 25% alternative capital gains tax paid by a personal holding company on Form 1120, is deductible from non-capital-gain income in computing the undistributed income subject to tax; so that a company on the accrual basis having $80,000 of long-term capital gain and $25,000 of other income, would have no personal holding company tax to pay even if there were no distribution, by reason of the fact that the $5,750 of ordinary tax on the ordinary income, plus 25% tax on the $80,000 of long-term gain, would effectively wipe out the non-capital gain income for the purpose of the personal holding company computation.

It is worth observing also, that, in the case of a personal holding company with long-term capital gains, the limitation on contributions of 15% is computed on the entire income, including

the long-term capital gain, and that deduction may be offset against the non-term capital gain income which otherwise would have to be distributed to avoid the tax.

A special problem comes up in connection with personal holding companies that have embarked upon liquidation. In the case of companies not in process of liquidation, dividend payments are deductible in computing the personal holding company income even if there is a large deficit from prior years, and even if current capital losses exceed the ordinary income so that there are no earnings available for dividend distribution despite the existence of net income subject to the personal holding company tax. In the case of a company in liquidation, the allowable credit for distribution to shareholders is limited to the amount of post-1913 earnings and profits accumulated at the time of the distribution in liquidation. That would mean, ordinarily, that a company with a very large deficit—larger than the current year's earnings—or a company with no accumulated earnings and having current capital losses in excess of its ordinary income, could not obtain a credit for personal holding company purposes by reason of its distribution in liquidation.

Several years ago the Circuit Court of Appeals for the 2nd Circuit held, in the *Pembroke* case, that in making a distribution in complete liquidation a company should be relieved of the personal holding company tax, on the ground that it had distributed all the earnings that it had, and nothing remained to be distributed. During this year, the *Brooklyn National* case came up in the 2nd Circuit, presented a similar issue, and the Court, finding before it a decison of the Tax Court which conflicted with the Court's prior decision in the *Pembroke* case, stated that it disagreed with the Tax Court, that the Circuit Court was right in its own prior decision in the *Pembroke* case, but that it could not reverse the Tax Court this time because of the rule of the *Dobson* case; whereas, the same decision had come before it for review by an appeal from a District Court, it would have been compelled to reverse.

At the present time, in case of contemplated liquidation, where you have a large deficit situation, be sure either to pay a dividend well prior to commencement of liquidation or, if it is too late for that, reserve adequate funds in the company, claim the credit for the distribution on the strength of the holding in the *Pembroke* and the dictum in the *Brooklyn National* case and, if later you "come a cropper" on that, the reserved amount can be used to avail yourself of the deficiency dividends procedure provided in Section 506 or the code. This was approved by an informal ruling of the Commissioner some time back, but I would recommend that, in any case you have, you ask for a similar ruling in advance. Finally, the last course of procedure that is open, if you are in the 2nd Circuit, is that if you have the fight on this issue, don't go to the Tax Court; pay the tax, file refund claims, bring suit in the District Court, and you will know that the Circuit Court will be with you if no contrary decisions have intervened in the meantime.

Chairman Lasser: Norris Darrell has agreed to discuss "Some of the Problems that Confront us in Section 112(g)6 Liquidations".

Norris Darrell: When one is confronted with the problem of liquidation of a subsidiary into a parent, it is not sufficient, as we all know, to look only at the immediate facts pertaining to the liquidation transaction and to measure them against the statute, but one must look at other things including the setting of the transaction.

Suppose the subsidiary had been a party to a reorganization transaction, and the liquidation—which, if looked at alone, would fit 112(g)6, was incident to the reorganization. If the liquidation is part of the reorganization what risk is there that the Courts would say Section 112(b)(6) does not apply and that any "boot" the parent receives

in the liquidation is taxable as a dividend under Section 112(c)(2)?

Also, suppose the stock of the subsidiary had recently been purchased, and the liquidation was contemplated from the outset because the parent really wanted to acquire the assets? In that case, is the parent simply completing a purchase, or does Section 112(g)6 apply? The question may be important from the standpoint of asset basis.

These illustrate the importance of considering all the surrounding circumstances when a liquidation problem is presented to you. But, assuming these questions are eliminated, what are some of the other questions one must consider under Section 112(b)(6)?

Well, one is, do the assets consist solely of cash? If the assets of the subsidiary consist solely of cash, does 112(g)6 apply? As we all know, the Tax Court has held not, but the 6th Circuit, in the *Tri-State Steamship Company* case held the reverse. We do not yet have a final answer to the question. The Tax Court held the same way, also, in the *Stimson* case, but the decision was affirmed by the Ninth Circuit Court of Appeals on other grounds. Personally, I believe that Section 112 (b)(6) ought to apply to cash liquidations if you consider the history of the statute and the theory behind Section 112(g)6 as amended in 1936. On the other hand, the liquidation of a subsidiary having solely cash certainly looks like a closed transaction, and the Courts might come to this view.

Suppose the assets consist of accounts receivable, which are perfectly good and collectible. This is quite possible nowadays in connection with the wind-up of war projects. When there is nothing left in a subsidiary but claims it may be desired for several reasons to liquidate the subsidiary into the parent. I am somewhat disturbed over this type of situation. I know of no authority, except the *Lehn & Fink* case. There it was held that an account receivable collectible at any time was not to be treated as money but as an asset, whether worth its face value or not.

Recently, another new question has been injected into Section 112(b)(6), namely, must the parent continue to hold the assets of the subsidiary following the liquidation? That point was brought into the picture by the *Fairfield* case, which George Cleary has just talked about. In its original opinion, the Second Circuit held Section 112(g)6 inapplicable to a liquidation where the parent intended immediately to dispose of the subsidiary's assets. The *Gregory* case principle was thought to apply to Section 112(c)(6). Now, of course, the applicability of this principle had no real bearing upon the outcome of that case, but the Court laid it down and did not take it back, and it is a view which has considerable plausibility and is something with which we must hereafter be concerned. How this doctrine fits into the decisions dealing with cash liquidations we can only guess.

Another question you must ask yourself is whether the liquidation will relieve a solvent subsidiary of debts which exceed its asset basis. Suppose the subsidiary has a large amount of debts, and assets costing very little but worth a great deal. There is a possibility that, if the discharged or assumed in the liquidation debts exceed the basis of the subsidiary's, the subsidiary will be deemed to realize income on the theory it is in effect selling its assets in consideration of being relieved of its debts. It has been thought by some that this same principle might apply to any assumption or cancellation of debts as part of a liquidation, but I think this unlikely. As a matter of fact, none of this has heretofore caused trouble as the taking over of obligations by the parent is usually treated as a natural part of the liquidation. Yet there are cases which it would be wise to clear with the Treasury before proceeding.

Suppose the subsidiary holds bonds of the parent which have a basis to the subsidiary of less than face value? On the liquidation, will the parent realize income by virtue of acquiring its own bonds at a cost less than the amount owed? In the Regulations under Sup-

plement R, the Bureau has a provision to the effect that ordinary income is realized in such a situation, and there is a possibility that, on similar reasoning, Section 112(b)(6) will be deemed not to cover it.

Is the subsidiary insolvent? There are several cases which hold that where a subsidiary is insolvent, Section 112(g)6 does not apply because in such a case the assets are distributed in satisfaction of debts and nothing is distributed in cancellation or redemption of stock. However, it has been the experience of many of us in practice that, where you have a reasonably close case, you can get a clearance with the Treasury under 112(g)6 if you agree to the carry-forward of basis.

Are there any other pitfalls to be concerned about? Well, as you know, there is the problem of losing the carry-forward or carry-back of net operating losses or the carry-forward of net capital losses. Similarly there is the problem of losing future deductions for unamortized discount on bonds of the subsidiary assumed by the parent in the liquidation, as well as deductions for taxes and other obligations and interest thereon which would ordinarily be deductible by the subsidiary if it continued. If these items are assumed by the parent and the parent pays them, there may be no tax deduction. If you encounter any serious problem of this nature, you should consider the effect of liquidating by merger. Liquidation under Section 112(b)(6) by merger is recognized in the Regulations. If you can liquidate by statutory merger, it is possible that at least some of the deductions I have just mentioned will not be lost. The law, however, is still unsettled on this point. Where the subsidiary has a low basis for its assets, it is desired to avoid Section 112(g)6. Can this be done where the parent possesses 80% stock ownership? I have always felt a bit unhappy about what the Courts would do to such attempts. It ought to be possible to avoid Section 112(b)(6), since it is supposed to be optional. The *Zimmerman* case, the company sold more than 20% of its stock to the treasurer—a bona fide sale before liquidation—in order to avoid the application of 112(g)6. The plan worked in the Tax Court and in the Circuit Court of Appeals. However, it is highly important that any such sale be bona fide. Also, if such sale is proposed to be made after the liquidation plan is adopted and the subsidiary is in the process of liquidation, you should consider that other line of cases suggesting that the stockholder is then simply selling the right to receive the proceeds. Whether this concept applies in Section 112(g)6, I do not know, but it is better to sell in advance if you are going to sell at all.

I shall take time to refer to only one other thing and that is the effect of a Section 112(b)(6) liquidation on earnings and profits of the parent. I am not sure that the law is settled on this point; but it would appear that the earnings and profits of the subsidiary will go forward in tact to the parent; that any gain or loss realized by but not recognized to the parent will be ignored; and that if the subsidiary has a deficit in its earnings and profits account that deficit will be ignored despite the curious result from an accounting standpoint.

Chairman Lasser: Mr. Tarleau is going to discuss "The Effect of the Sales Following Recapitalization".

Thomas F. Tarleau: As I understand the topic that I am to talk on tonight, it is the question of "What Kind of Recapitalizations Followed by Sale of Stock Will Stand Up." That is the expression that is contained in the letter that Mr. Lasser sent to me.

Now, as I understand the question, it involves the situation where there is a recapitalization and the stockholders, for one reason or another, desire to sell some of the new securities that they receive.

The term "recapitalization" is used in the question that was given to me, but even such a thing as a stock dividend—a non-taxable stock dividend, which so closely resembles a recapitalization—is involved in the question.

For example, Mr. A owns all the common stock of Corporation X. Mr. A decided that he will have a recapitalization of X and he will have issued to himself, in the recapitalization, new preferred stock, and, as part and parcel of the whole plan, he has an understanding with underwriters that they will take off his hands and sell to the public the preferred stock which he receives on this recapitalization.

Now, naturally Mr. A is interested in two phases of this problem. In the first place, he is anxious that the recapitalization stand up as a tax-free exchange—that is, the exchange of his old stock for the new common and preferred be tax-free. In the next place, he is very much interested in seeing that when he sells the new preferred stock, the proceeds he receives from the sale of the new preferred stock will be considered as capital gain.

Now, quite obviously, the big object on the part of a great many people today is to get cash by way of capital gains rather than cash by way of dividends; and quite obviously it is the Treasury's purpose to prevent that to the greatest degree possible. One of the places where the struggle seems to impinge is on this question of recapitalization, or stock dividends, or other form of corporate reorganization, when new securities are received for old and, immediately thereafter, some of the new securities are sold.

Now, what is the trouble with such a problem? Why can't Mr. A, receiving new securities of Corporation X in exchange for old securities, sell some of the new securities and immediately realize only a capital gain?

Well, one of the problems that confronts the Treasury in examining a transaction such as this and which may make the transaction vulnerable, is what is the underlying purpose of this recapitalization or this reorganization? There is nothing more dangerous in the whole practice of the law of taxation than to take one of these reorganization sections and read it literally and then believe that the question is answered. Certainly in the *Strassburger* case and in the *Sprouse* case, the Supreme Court decided that the issuance of a preferred stock dividend, where there is only common stock outstanding, is nontaxable, and certainly the Internal Revenue Code provides there shall be only capital gain or loss recognized on the sale of a capital asset; but this must be read against a background of action.

Suppose Mr. A, for example, the sole stockholder of the corporation who has exchanged in a recapitalization all his old common stock for new common and preferred, plans to sell the preferred to underwriters and, shortly thereafter, to have the preferred stock redeemed by the corporation. You will notice that as a result of this transaction, Mr. A, the sole stockholder, at the termination of the scheme, is again the sole stockholder but with cash which he received on the sale of the preferred stock. Will such a transaction stand up? Will the receipt of the new securities for the old be considered a tax-free reorganization? Will the sale of the preferred stock for cash be considered a capital transaction?

The Treasury today is examining those cases very carefully; and what is it looking at? In the first place, it relies on such cases as the *Bazley* case and the *Adams* case and some of the language in the *Bedford* case to try to see whether or not there is a business purpose back of the recapitalization or the reorganization. As was said in the 3rd Circuit Court of Appeals, in those cases a recapitalization must have a corporation business purpose; that is to say, it must have a purpose evidenced by the necessities of the business of the corporation and germane to its continued business existence. And, in the second place, as an empirical test, the Treasury looks very closely at what the balance sheet position of the corporation is like and what the terms of the securities that are sold contain.

For example, let us assume that a corporation which has large accumu-

lated earnings, which has large amounts of cash or liquid assets, and which is closely held has a recapitalization, issuing new common and preferred for old common, and that the preferred stock which is sold to the public is a preferred stock which has a very short sinking fund provision (that is, the stock can be redeemed, let's say, in five or ten years—must be redeemed in that time by reason of the sinking-fund provisions) in which there are very liberal call provisions; that there seems to be no corporate business purpose other than to enable the individual to sell the new security and realize cash therefrom—the Treasury becomes suspicious and calls these cases "bail-out cases". In other words, all the individual is trying to do is to take cash from a corporation by means of getting a security, selling it to the public, then having the security redeemed by the corporation.

This "bail-out" development is a growing one. It is a new one. There are no cases that one can rely on, directly, on point. One can rely on, however, the attitude of the courts on corporate reorganization in general.

The *Bazley* and the *Adams* cases followed a series of cases such as *Annis Furs, Clarence Sohoo,* and various other cases in which the term "recapitalization" was given a rather broad meaning by the courts, and corporations were allowed to burden themselves with a new bond issue for no other reason, very frequently, than to enable the security holder of the corporation to benefit by the arrangement. You know what has happened in the *Bazley* and the *Adams* cases where the 3rd Circuit Court of Appeals affirmed the Tax Court, and the Supreme Court recently granted certiorari.

The new type of recapitalization where bonds are not used but a preferred stock which closely resembles a bond in its length, in its terms, in its feeling that sooner or later—and usually sooner—it will be called in, is now coming under the eyes of the Treasury. In my opinion, the type of recapitalization that should stand up in a recapitalization followed by a sale of stock—is a recapitalization where there is a good corporate reason, a good corporate purpose, for the recapitalization; in the second place, where the corporate picture itself indicates that it is unreasonable and unlikely that the corporation will very quickly redeem the preferred stock which is being sold by the old security holders; and, finally, where it is a transaction where the security holder has no agreement, express or implied, with the persons to whom he sells his new securities, that those securities will be called in within the near future. Any other type of recapitalization—any other agreement to translate what would otherwise be ordinary income into capital gain—is, to put it mildly, at least dangerous. It is a development which has not yet found its way into the courts, but it is a development which finds its way in practice and which the Treasury now, for the first time, is seriously concerned about.

Chairman Lasser: "What kind of increases in salaries will be approved by the Bureau and by the Tax Court?"

Benjamin Grund: I suppose a wise man would say, "A reasonable increase", and let it go at that; but we should try to answer these questions.

Section 23(a)(1)(A) of the Internal Revenue Code allows as a deduction all the ordinary and necessary expenses, including a reasonable allowance for salaries or other compensation for personal services actually rendered. The test of deductibility is whether the salaries are reasonable and are in fact payments purely for services. Distributions of profits are not deductible.

The Tax Court has indicated that it will allow increases in salaries where the transactions are at arm's length and the increases were reasonable at the time they were arranged.

In testing whether a payment is a distribution of corporate earnings in the guise of compensation, the Court generally refers to such factors as (1) the stockholdings of the respective officers,

(2) the time when the salaries were voted and whether at such time the corporate earnings had increased, (3) the salary history of the corporation and of the officers, (4) the services rendered by the officers and the impact of said services on the corporate business, and (5) the dividend policy of the corporation. The Court may expect a showing of either competitors' salaries or expert testimony as to the value of the services of the officers.

From these criteria we can conclude that the Bureau and the Court will recognize increases in compensation under the following circumstances:

(1) Duties and responsibilities and the value of the services of the officers had increased. In that connection a change in the business, in its volume, in the time required of the officers, and replacement of other personnel are some of the factors to be considered. Prior years' salaries may not be a criterion if inadequate compensation was paid in prior years either because of the need for conserving corporate funds during a period of growth, to minimize losses, or for other proper reasons.

(2) Services only are being compensated and the payments to the officers are not a distribution of profits. The fact that the compensation is in proportion to stockholdings is not necessarily indicative since stock may have been issued in the first instance in proportion to the value of the services being rendered by the officers, capital invested and services rendered being on the same proportionate basis.

(3) Salary arrangements are not made at the end of the year but at arm's length either at the beginning of the year or prior thereto.

(4) Bonus arrangements based upon profits, sales, etc. are proper, if reasonable when made, although payments in retrospect otherwise may appear large.

(5) Compensation payments are made on a basis of meeting actual competitive offers.

(6) After payment of salaries, capital earned a fair return and either reasonable dividends are being paid or the earnings are being retained for the business needs of the corporation.

(7) Salaries are voted by an independent Board of Directors.

Necessarily, all of the foregoing factors may not be present in every situation, particularly in the case of close corporations where informality frequently prevails, and attention to technical detail and refinements is as often disregarded as observed.

Note the tendency of the Tax Court to by-pass Dean Griswold's recently expressed views with respect to the Commissioner's inability to attack excessive compensation by emphasizing that the disallowed amounts are in fact distribution of profits and not compensation. The views of Dean Griswold were apparently intended to apply not to salaries paid officers of close corporations but rather to salaries paid to the management of publicly owned corporations voted by an independent board of directors.

Chairman Lasser: One of the normal plans for reorganization today contemplates a change in a business structure in order to secure an interest deduction instead of a dividend payment. Mr. Rabkin is going to discuss that.

Jacob Rabkin: As a lawyer I was somewhat intimidated by the prospect of talking to so many accountants, but when I heard your Treasurer's report I was confident it was prepared by lawyers. I feel, therefore, that I can discuss with you briefly the legal, judicial history of the problem that has been given to me.

In 1935, the Circuit Court of Appeals for the 2nd Circuit decided the *O. P. P. Holding Company* case in which it held that interest was deductible on a debenture even though the debenture was subordinate to the claims of general creditors, and even though the corporation had a right to postpone, in its discretion, the payment of interest.

Ten years of history followed that case, in which the question was whether an instrument fell on one side or the other side of the *O. P. P.* instrument. That ten years of litigation culminated in the two Supreme Court cases decided January, 1946: the *Talbot Mills* and the *Kelly Company* cases. I don't want to go into the definition of what type of instrument is a debenture and what type of an instrument is a stock. Assuming that, as competent tax men, we know how to prepare an instrument which is an indebtedness on its face, can there nevertheless be created a situation in which the interest on that debenture would not be deductible?

Ten years after the *O. P. P.* case was decided, the Tax Court decided the disturbing *1432 Broadway Corporation* case in which it held that an instrument substantially the same as the instrument in the *O. P. P.* case could not be the basis on which to predicate a deduction for interest.

In April, 1946—about four or five months after the *1432* case—the final step in the current history of that question came before the Tax Court in the *Cleveland Adolph Mayer Realty Company* case in which here, again, an instrument which largely resembled the *O. P. P.* instrument and the *1432* instrument, was held by the Tax Court to be sufficient to warrant the deduction of interest.

Now that is a confused history. Why is it that, in the *1432* case, the deduction was not allowed? There were four reasons, in the *1432* case, why the Tax Court felt that interest was not deductible; two of them I can dismiss rather quickly.

If you recall, in the *Talbot Mills* case and the *Kelly* case, the Supreme Court made the statement that if you had an obviously excessive debt structure— in other words, if in the creation of a debt you had insufficient underlying properties—that that instrument or that debt was not a real bona fide debt and therefore the interest was not deductible. There is a rather ambiguous and unfortunate statement in the *1432* case on this point. The Tax Court said the property in that case had a value of "\$1,200,000, (maybe more)" and then went on to point out that there was a \$300,000 mortgage on the property. On this basis the issuance of \$1,200,000 worth of debentures would appear to be an excessive debt structure.

Actually, the only evidence before the Tax Court on the issue of value was the evidence of a reliable appraiser who appraised the property in 1931, when the company was organized, at \$1,500,000. The Tax Court was apparently confused because of mortgage, and assumed that the value of the property was \$1,200,000 instead of \$1,500,000. We can dismiss that point by saying that if the structure of the debt is excessive, the interest will not be allowed.

The second point raised by the Tax Court was the fact that ownership of the debentures was in the same proportion as the ownership of the corporation's stock. Oddly enough, that fact was in the *O. P. P.* case and is the *Adolph Mayer* case. We can dismiss that, then.

On the third point, it appeared in the *1432* case that the debt structure was created in consideration for the transfer of property to the corporation upon its incorporation. The court made the very startling statement that you cannot have an interest deduction unless you lend money to a corporation. That is one of the most remarkable statements made by a modern court. In this era of progressive taxation, that statement has a semblance of liberalism and realism. Actually, it is an unfortunate statement which turns back the clock on centuries of history. If the statement had been made between the thirteenth century and Blackstone's time, it might have been acceptable, because, during that period of time the action for debt did not rest upon contract, but was essentially an action to recover specific property, so that if you sued for thirty pounds and only proved a claim for twenty you lost your action,

just as you would lose if you sued for a cow and showed you were entitled to a bull. The point is that we have reached a period in the development of our contract law where we recognize that a debt can be created by a promise for payment made upon the delivery of property and that the payment of money is not the only way in which to create a debt. I believe that the Circuit Court will repudiate the Tax Court on the proposition: that you cannot get a tax deduction for interest unless money is contributed to a corporation.

The final point in the Tax Court analysis is the crucial point. It made the statement that the corporation—the *1432 Broadway Corporation*—had not paid interest on its debt. That is the only distinguishing factor between the *1432* case and all of the other cases that I mentioned. Why did the Tax Court refer to that fact? Obviously because the Tax Court wasn't satisfied with the statute. If the *O. P. P.* case is still the law and in that case the corporation had the right to postpone the payment of interest, certainly the exercise of that right by an accrual basis corporation shouldn't change the law.

The Tax Court was somewhat disturbed by the fact that there is a dangerous potential tax avoidance device in the accrual of interest on a debt where the owners of the debentures are cash-basis taxpayers. It, therefore, legislated a provision into the statute. Congress itself had been concerned with this question of interest deduction between related taxpayers and, in the 1937 "loop-hole" act, had introduced and prescribed a modified solution to that problem. It introduced Section 24(c) into the Code. The Tax Court wasn't satisfied with that solution of the problem, and it was because of the non-payment of the interest, I believe, that the Tax Court found against the taxpayer in the *1432* case. I think this type of judicial legislation is not permissible. It is for this reason that I believe the *1432* case should be reversed upon the present record.

Chairman Lasser: The last of our Committee of distinguished attorneys is going to talk to you about a problem which is typically legal:—In what tribunal should tax cases be instituted today? Should a deficiency case be tried in the Tax Court or is it more desirable to litigate tax matters in the District Courts. Mr. Everett!

Ewing Everett: Mr. Moderator and Gentlemen: There is only one infallible criterion for determining the right tribunal in which a Federal tax case should be instituted. The answer is determined as follows: You have received an official-looking envelope which bears no postage stamp and carries a notation relating to a penalty for private use. After hurriedly skimming through the mimeographed contents you concentrate upon the closing phrases which read as follows: "We are of the opinion that the respondent's determination must be sustained. Decision will be entered under Rule 50." At this point and only then you may be positive that you tried your case in the wrong court!

However, prior to the *Dobson* case (which was decided about three years ago) the tax attorney would not have been too greatly concerned merely because the Tax Court arrived at the wrong answer. After sending in a bill for an additional retainer to cover his services in the appellate courts he would have proceeded to the appropriate Circuit Court of Appeals and in due course might have presented his case to the Supreme Court of the United States, confident that the errors of the Tax Court would in time be corrected. The advent of the *Dobson* case, however, substantially curtailed appellate review in cases arising in the Tax Court. That decision, which has now been cited in several hundred cases, laid down a general principle of law which in substance means that the Tax Court is so well qualified to deal with Federal tax problems that rarely should an appellate court reverse a decision of the Tax Court and should never reverse such a

decision unless a pure question of law is involved. However, even after the *Dobson* decision there still remained a goodly number of cases in which the appellate courts considered and reversed Tax Court decisions.

But recently the Circuit Court of Appeals for the Second Circuit has further limited the right of appeal in cases which come to it from the Tax Court. This new rule appears in the *Brooklyn National Corporation* case (decided in July of 1946) which was mentioned by Mr. Austin and which has been characterized by some people as "the greatest dodging decision that ever originated in Brooklyn." In that case the Second Circuit held that a liquidating distribution was not a deductible dividend for the purpose of determining "personal holding company" taxable income. In a previous decision rendered by the same Court (the *Pembroke Realty* case) it had arrived at a different conclusion. In the *Brooklyn National Corporation* case Judge Learned Hand indicated that the Court still felt that its views expressed in the *Pembroke Realty* case were correct. He stated, however, that because the Tax Court had reached a contrary conclusion, the Second Circuit must, of necessity, affirm the decision of the Tax Court because of the views expressed by the Supreme Court in the *Dobson* case. He went on to say: "Before we may substitute our own interpretation of a provision of the Revenue Act, not only must a naked question of law detach itself from the nexus of law and fact in the record as a whole; but we must conclude that the Tax Court has been indubitably wrong in its decision of the question which emerges: reasonable differences in legal opinion we are to resolve in its favor." In a dissenting opinion, Judge Augustus N. Hand said that he did not believe that the dice were so heavily loaded against any decision of an appellate court which differed from the views of the Tax Court. He added that he did not believe that the *Dobson* decision called "for complete abdication on our part."

The majority opinion in the *Brooklyn National* case would indicate that the Second Circuit will review decisions of the Tax Court only where a question of statutory interpretation is presented absolutely "in the nude". If so much as a fig leaf of fact is superimposed upon an otherwise naked question of law, the Court apparently feels that it can do no more than affirm the decision of the Tax Court, however wrong that decision might be. Further, it would appear that even where a naked question of law is involved the decision of the Tax Court will stand unless in the eyes of the Second Circuit it is *indubitably* wrong. The difference between a wrong decision and one that is indubitably wrong is a refinement which requires microscopic inspection.

Since Judge Hand clearly indicated in the *Brooklyn National* case that if that case had come before the Court on appeal from a decision of a District Court it would have reversed the decision, it may be assumed that litigation in the District Courts will greatly increase, especially in those situations where appellate review is desired. I think that this is true. However, it does not follow that all such cases will be brought in the Federal District Courts. There are numerous other considerations which must be borne in mind. In some instances, such as claims for relief under Sec. 722, the Tax Court has sole jurisdiction. Most tax cases arise out of deficiencies proposed by the Commissioner of Internal Revenue. In such cases a District Court has jurisdiction only where the taxpayer has paid the deficiency and has filed a claim for refund. Where large amounts are involved such a procedure may cause serious financial embarrassment to the taxpayer who, even though he may be eventually successful, is deprived of the use of his money for a long period of time while the case is in the process of litigation. Further, it is well known that a great many tax deficiencies are

settled on a compromise basis while such cases are pending in the Tax Court. From a psychological standpoint it is probably easier to effect a compromise settlement of a deficiency claimed by the Government than to effect a compromise after the tax has been paid because such a compromise involves refunding of taxes rather than a reduction in additional taxes claimed.

In conclusion it may be stated that if the views of the Second Circuit are generally followed, the volume of tax litigation arising in the District courts will in all probability substantially increase. However, run-of-the-mill cases will probably continue to be tried in the Tax Court and no doubt that tribunal will continue to operate at a capacity which will continue to keep most of us several weeks behind in reading the "advance sheets".

Chairman Lasser: A great many changes are occurring in partnership structures due, in part, to the disparity of rates between the corporation and partnership and a desire to dispose of partnership assets. Mr. Mills is going to talk about "The Methods and the Mechanics of Disposing of Partnership Assets".

Leslie Mills: Mr. Rabkin, who is dignifying this platform tonight, has said, in one of his informative tax articles, that "the partnership is encased in a semi-permeable shell: it is recognized to the extent that it serves accounting convenience, but the basic taxpaying unit is the individual partner". One result of this semi-permeability is that while a sale or exchange of partnership property by the partnership will be reflected currently in the taxable income of the individual partners, transfers of property between the partnership and its members ordinarily will not create gain or loss taxwise.

Thus, in disposing of an individual item of its property, every partnership has the choice of either (1) selling or exchanging it on behalf of the partnership, or (2) distributing the property to the partners for disposal by them individually. Under the first method, the profit or loss will be determined for the partnership, and will be reflected in the individual partners' tax returns in accordance with the Internal Revenue Code applied to the partnership agreement. If the second method is followed, there will be no taxable income realized by either the partnership or its members, and the partners will determine the tax effect to themselves individually as they dispose of the property they have received. Since there are different rules for computation of basis for determining gain or loss on sale or exchange under the two methods, considerable difference in tax may result.

If the partnership sells at a profit an asset which it had acquired by purchase, the resulting gain will be measured by its basis of cost, and will be taxed to the partners in accordance with the partnership agreement. If the property sold was a capital asset, the partners' share of the profit will be capital gain to them. However, if the partnership distributes the property in kind, there will be no taxable profit or loss to the partners until they dispose of the property, and the gain or loss to them at that time will be measured not by the partnership cost but by an allocation of their individual basis for their interest in the partnership. This allocation is made on the basis of fair market value, at the time of the distribution, of all partnership property including that distributed.

The effect of this rule can be shown by two general observations. First, if the basis to the partners for their interests in the firm are not in the same proportion as their interest in partnership profits, their gain or loss on sale (at the same time) of property received as a distribution in kind will be in different proportions than would have been their share of gain or loss if the property were sold by the partnership. It also follows that there will be different reductions of the basis of each partner for the continuing interest in the partnership. Second, if the computation of fair market value of the assets of the partnership reflects unrealized

appreciation or depreciation, there will be a difference in total gain or loss to the partners on sale under the two methods, even if each partner has the same basis for his interest.

For example, assume a partnership of two partners with equal capital contributions and equal interests in partnership profits. If the partnership assets have doubled in value through unrealized appreciation and it sells at no profit or loss a purchased asset representing 10% of the value of its total assets, there will be no taxable income to the partners. However, if the partners received that asset in a distribution in kind, their basis for it would be 10% of the basis for their partnership interest, and sale by them would result in a gain of 50% of the proceeds. This situation results from the application of the rule in the computation of the basis for the property, since 10% of the fair market value of the partnership assets would be equivalent to 20% of the total basis to the partners for their interests.

Increased difficulty can result if the property in question was acquired by the partnership as a contribution to capital by a partner, since such property will have a basis to the partnership equal to its basis to the contributing partner. In such a case, upon sale of the property by the partnership, there will be reflected the unrealized appreciation or depreciation as of the time of the contribution to capital. In the absence of specific provision in the agreement as to distribution of partnership profits, the amount of this unrealized appreciation or depreciation will be reflected in the allocation of partnership taxable gain or loss to the contributing partner. Thus you can have the unusual situation of a sale of property by a partnership resulting in a gain to one partner and a loss to another partner. If such contributed property is distributed in kind and sold by the partners individually, the principles outlined previously will be followed.

The above comments have been directed to the disposal of an item of partnership property. It has been indicated that gains or losses on sales of partnership capital assets are capital gains or losses to the partners. If the partnership is being liquidated, the same choice as to sale or distribution in kind is available. The general rule stated above, that no gain or loss results from distributions in kind, applies also to liquidation distributions by a partnership. In some cases, if the assets received consist mostly of cash plus some property of a definitely ascertainable market value, it may be evident that a loss has resulted. There is support for the position that in such a case an immediate tax loss has been realized.

Partners may agree as they wish on how partnership profits are to be divided. Every partnership should survey the tax effect of disposal of its assets, and should be sure that the tax consequences of the method adopted for disposal will give a result in accordance with the intent of the partnership agreement. And, finally, it should be remembered that the statutory provisions as to disallowance of losses on family transfers and wash sales apply to partnership transactions.

Chairman Lasser: "How Much Should Corporations Pay out in Dividends in November and December?" Mr. Mark Richardson!

Mark S. Richardson: I would like to approach this subject more from the public accountant's point of view than from the businessman's point of view as to the question of what dividend should be paid.

We have the problem of telling many of our clients what dividends should be paid, because they expect us to. Let's face some of the problems that we have in helping them with that problem of theirs.

First, we know now that the new 1120 form is going to contain a question as to whether or not the corporation did distribute 70% of its earnings after taxes. We have the serious problem of convincing our clients that, by being able to answer that question yes, they

do not automatically avoid the possible imposition of surtax under 102. We also have the problem of convincing them that they had better take the question seriously, because in all probability to answer the question no is going to be accepted by the Treasury Department as a statement, "We think you ought to try to apply 102 to us."

Now I know that the Treasury says that isn't the intention, but I think we have to approach it as though it were the intention. We have to face the fact that many of our clients have convinced themselves for years that they had a lot of good reasons why they had to retain their earnings—that they were going to do this and going to do that when the war was over, and they couldn't buy this now but they were going to—and they have gotten sold on how good their story was, and their story probably isn't nearly as good now. In fact, it doesn't even sound like the same story, in many cases. They have accumulated, in many instances, so much surplus now, that any story as to what they are going to do with it has got to be a big improvement on what it has been for several years.

And the reason why I think we have to face this now is because it may be our last opportunity to answer this question when it gets into the form. It is going to be rather difficult to convince the technical staff, three or four years from now, that there were a lot of reasons why we didn't distribute our earnings which we couldn't think of right now when we answered the form. As to that difficulty of proof, let's realize that the Dobson rule you have heard so much about is probably a lot more serious in a 102 case than it is in most others.

No matter how capable the attorney—and I am not throwing any disparaging remark at this panel, because if anybody could find an answer these gentlemen could—he is going to have difficulty in finding a question of law in this 102 situation, which is purely, in most instances, a question of fact as to whether there was or was not an improper accumulation of surplus.

Two more questions remain that may be all that can be discussed within this seven-minute time allotted. The question invariably turns up, "Well, can we pay dividends after the end of the year and avoid 102 in that manner?" As a generalization, "Yes, because you cannot be accused of avoiding the imposition of surtax if you have paid out your earnings and surtax is going to be imposed. But let's not forget that doesn't apply (as somebody tried to apply it recently) where the president of the company was paid an exceptionally nice salary one year and then retired and wasn't paid anything the next year, and they decided to pay him the dividends in January instead of the previous year. Naturally they avoided surtax by waiting until the next year. When it is a sound and consistent dividend policy—paying those dividends as of the end of the year—still holds as a good defense against 102.

The other problem that I'd like to point out: Let's not lose track, as advisers to clients, of the fact that the net operating loss deduction which is allowed for normal tax purposes, is not allowed for 102 purposes. Let's not face 1946 thinking, "Oh well, we're going to have a loss in 1947, so we'll have a carry-back that is going to wipe out all of our income for 1946." Maybe you will. But, for 102 purposes, it doesn't wipe it out, because you do not have a loss carry-back for that purpose, you only have the old "net operating loss deduction" part of the basic surtax credit, which is a one-year carry-forward not a carry-back at all. We can have some serious consequences on that if we forget that little technicality.

Consolidated Profit and Loss Statements of Fiscal Year Companies for S. E. C. Requirements

By CHARLES WEITZ, C.P.A.

THE recent deluge of new public financing of the past year, with its consequent filing of registration statements with the Securities and Exchange Commission under The Securities Act of 1933 and The Securities Exchange Act of 1934, has brought forth an interesting approach to consolidated profit and loss statements where the registrant and subsidiaries have different closing dates.

The Commission's rule[1] for consolidated statements of the registrant and its subsidiaries is that generally accepted accounting procedures are to be followed in the preparation of statements and that

"(a) The registrant shall not consolidate any subsidiary which is not a majority-owned subsidiary;

"(b) If the statements of a subsidiary are as of a date or for periods different from those of the registrant, such subsidiary may be consolidated only if all the following conditions exist:

"(1) Such difference is not more than 93 days;

"(2) The closing date of the subsidiary is expressly indicated;

"(3) The necessity for the use of different closing dates is briefly explained; and

"(4) Any changes in the respective fiscal periods of the registrant and the subsidiary made during the period of report are clearly indicated, together with the manner of treatment."

For majority-owned subsidiaries not consolidated with the registrant, separate financial statements may be filed, or group statements if it is essential to a proper presentation of the facts.[2]

The above applies to commercial and industrial corporations, as special rules apply to insurance, investment, banks, bank holding, and public utility holding companies.

The reason for the Commission's 93 day rule is that a registrant may have subsidiaries in distant parts of the country, or in foreign lands. Since it takes a longer period of time to perform an audit under these conditions, some corporations have adopted the procedure of having their distant subsidiaries close their books one to three months prior to that of the parent company. This facilitates the preparation of the consolidated statement and

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(1) Securities and Exchange Commission, Regulation S-X, Form and Content of Financial Statements, 1944, Rule 4-02.

(2) Ibid, Rule 4-03.

makes the report available within a more reasonable period of time.

This practice is in accordance with the recommended procedure of the American Institute of Accountants.[3]

"In the case of consolidated statements, it is frequently desirable to examine the accounts of operating subsidiaries as of a date a few months prior to the close of the parent company's fiscal year; otherwise the issuance of the financial statements might be unduly delayed. In such cases a review of the transactions between the date of the examination and the date of the consolidated accounts should be made.

"In the case of foreign subsidiaries in particular, it is frequently impossible to receive the financial statements as of the date of the consolidated balance sheet in time for inclusion in such balance sheet and it is therefore customary to include the accounts of certain of the subsidiaries, in cases where they are consolidated, as of an earlier date. . . . The operations of each company should cover a full fiscal period."

In a recent filing with the Commission there was an interesting application of the 93 day rule. The registrant,[4] with operating subsidiaries with fiscal year closing dates more than 93 days apart, recast certain of the subsidiaries' profit and loss statements to reflect therein the transactions for a twelve month period, which is different from the subsidiary's generally stated accounting period. This was accomplished by the following explanation:

"In order to prepare income statements on a uniform calendar year basis . . . the income statements of the companies having fiscal years ending on a date other than December 31 were placed on a calendar year basis, using the following method of allocation:

"(a) Cost of sales:

The percentages of gross profit for the respective fiscal years were applied to the related calendar year net sales on a monthly basis. The amount of gross profit so determined for each calendar year was deducted from the net sales for that calendar year to arrive at the cost of sales.

"(b) Operating expenses, other income and other deductions:

The totals of operating expenses (except selling commissions and brokerage), other income and other deductions were allocated pro rata to the applicable calendar years.

Selling commissions and brokerage being directly related to net sales were accrued on an actual calendar year basis.

"(c) Federal income and excess profits taxes:

The percentage of federal income and excess profits taxes applicable to the actual net income of the respective fiscal years, were applied to the respective calendar years' net income, on a pro rata net income basis, as determined in (a) and (b) above."

An example will illustrate the point. Parent company A with wholly owned subsidiaries B and C have the following accounting periods:

	Fiscal year ending
Company A	December 31
Company B	December 31
Company C	August 31

Inasmuch as profit and loss statements for three fiscal years preceding the date of the balance sheet, plus a profit and loss statement covering the interim period, if any, between the close of the most recent fiscal date and the filing date, are required, the following statements are presented of Company C:

(3) Examination of Financial Statements by Independent Public Accountants, 1936, p. 36.

(4) Airline Foods Corporation (File Number 2-6118-1), Prospectus dated March 8, 1946, Herrick, Waddell & Co., Inc., underwriter.

COMPANY C

STATEMENTS OF INCOME—ACTUAL

	Eight months ended April 30, 1946	Year ended August 31 1945	1944	1943
Sales (less returns, allowances and deductions)	$3,000,000	$3,700,000	$3,200,000	$3,000,000
Cost of sales	2,400,000	3,000,000	2,600,000	2,500,000
Gross profit	$ 600,000	$ 700,000	$ 600,000	$ 500,000
Gross profit percentage	20.0	18.92	18.75	16.7
Operating expenses	500,000	640,000	550,000	460,000
Operating profit	$ 100,000	$ 60,000	$ 50,000	$ 40,000
Other income	20,000	25,000	26,000	21,000
Gross income	$ 120,000	$ 85,000	$ 76,000	$ 61,000
Other deductions	20,000	25,000	21,000	15,000
Net income before provision for federal taxes on income	$ 100,000	$ 60,000	$ 55,000	$ 46,000
Provision for federal taxes on income	50,000	40,000	30,000	26,000
Net income	$ 50,000	$ 20,000	$ 25,000	$ 20,000

Since it is desired to place the operating statements on a twelve month calendar year basis so that comparative figures may be obtained, recasting is necessary of the statements of Company C. No change is required for companies A and B, as their results are already stated for calendar years. Converting the operating results of company C from a fiscal year to a calendar year basis is effected by the following restatement:

COMPANY C

STATEMENTS OF INCOME CONVERTED TO CALENDAR YEAR BASIS

		1946	1945		1944			1943			1942
		January 1 to April 30	January 1 to December 31	September 1 to December 31	January 1 to August 31	January 1 to December 31	September 1 to December 31	January 1 to August 31	January 1 to December 31	September 1 to December 31	January 1 to August 31	September 1 to December 31
Sales (less returns, allowances and deductions)	(a)	$1,600,000	$3,800,000	$1,400,000	$2,400,000	$3,500,000	$1,300,000	$2,200,000	$3,100,000	$1,000,000	$2,100,000	$900,000
Cost of sales		1,280,000	3,066,000	1,120,000	1,946,000	2,841,500	1,054,000	1,787,500	2,562,500	812,500	1,750,000	750,000
Gross profit	(b)	$ 320,000	$ 734,000	$ 280,000	$ 454,000	$ 658,500	$ 246,000	$ 412,500	$ 537.500	$ 187,500	$ 350,000	$150,000
Operating expenses:												
Selling commissions	(a)	$ 80,000	$ 190,000	$ 70,000	$ 120,000	$ 180,000	$ 70,000	$ 110,000	$ 140,000	$ 50,000	$ 90,000	$ 25.000
Other	(c)	175,000	475,000	175,000	300,000	410,000	150,000	260,000	360,000	130,000	230,000	115,000
Totals		$ 255,000	$ 665,000	$ 245,000	$ 420,000	$ 590,000	$ 220,000	$ 370,000	$ 500,000	$ 180,000	$ 320,000	$140,000
Operating profit		$ 65,000	$ 69,000	$ 35,000	$ 34,000	$ 68,500	$ 26,000	$ 42,500	$ 37,500	$ 7,500	$ 30,000	$ 10,000
Other income	(c)	10,000	26,667	10,000	16,667	25,667	8,333	17,334	22,666	8,666	14,000	7,000
Gross income		$ 75,000	$ 95,667	$ 45,000	$ 50,667	$ 94,167	$ 34,333	$ 59,834	$ 60,166	$ 16,166	$ 44,000	$ 17,000
Other deductions	(c)	10,000	26,667	10,000	16,667	22,333	8,333	14,000	17,000	7,000	10,000	5,000
Net income before provision for federal taxes on income	(d)	$ 65,000	$ 69,000	$ 35,000	$ 34,000	$ 71,834	$ 26,000	$ 45,834	$ 43,166	$ 9,166	$ 34,000	$ 12,000
Provision for federal taxes on income		32,500	40,167	17,500	22,667	42,333	17,333	25,000	24,200	5,000	19,200	6,800
Net income		$ 32,500	$ 28,833	$ 17,500	$ 11,333	$ 29,501	$ 8,667	$ 20,834	$ 18,966	$ 4,166	$ 14,800	$ 5,200

(a) Actual.
(b) Based on percentage of gross profits to sales for the fiscal year containing the respective periods.
(c) The applicable monthly proportion of the fiscal year totals.
(d) Based on percentage of the total federal taxes to net income before taxes for the fiscal year containing the respective periods.

Selecting the actual figures for the eight months ended April 30, 1946, as an example, it will be seen that sales are prorated to the period January 1 to April 30, 1946, and to the period September 1 to December 31, 1945 on an actual basis. The actual gross profit percentage of 20.0 percent is applied to the respective sales amounts to arrive at the gross profit for each period. Under operating expenses, selling commissions are apportioned as to the actual expenditures incurred within the respective periods since they are directly related to sales. Other operating expenses are apportioned on a pro-rata basis, in this case one-half to each period. Other income and other deductions are divided in the same pro-rata manner. Federal taxes on income are charged to each period based on the percentage relationship of total federal income taxes to net income before federal income taxes. Statements of the fiscal years 1943-45 are recast in the same fashion. It is then possible to combine the fractional periods and arrive at operating figures for the calendar years 1943-45 and four months ended April 30, 1946 as shown by the restatement.

We are then in a position to prepare consolidated profit and loss statements for Company A and wholly-owned subsidiaries Company B and C.

In another recent filing[5] registrant prepared consolidated profit and loss statements for the fiscal years ended October 31, 1943, 1944 and 1945. The consolidation included the following:

3 companies	fiscal year ended January 31
2 companies	fiscal year ended June 30
12 companies	fiscal year ended October 31
3 companies	calendar year ended Dec. 31

The consolidated statement of profit and loss contains the note that "not all of the companies whose figures are included in the consolidated statement of operations have fiscal years ended October 31st. Consequently appropriate adjustments have been made in the cases of companies with calendar or other fiscal year closings so that their operations are also reflected in the consolidated statement on the basis of a twelve month period ended October 31st in each of the years above."

No further information is given as to what these appropriate adjustments were nor how they were made. However, note four to the statement gives the physical inventories at October 31st the beginning and end of the period for each of the years audited. Inasmuch as physical inventories were available to the accountants it was probably more simple to recast the operating statements of this company than for the former one.

In conclusion it may be stated that the principles illustrated here are of significance to accountants not only for the purpose of preparing statements for filing with the Securities and Exchange Commission but are of useful application wherever consolidated statements are required.

(5) Virginia Dare Stores Corporation (File Number 2-6118-1) Prospectus dated August 16, 1946, Kobbe, Gearheart & Company, Incorporated, underwriters.

Am I My Brother's Keeper?

By THOMAS W. BYRNES, C.P.A.

THE above words uttered by Cain in response to the Lord's inquiry "Where is Abel thy brother?" have a different significance today. In modern usage the expression refers to responsibility for the moral or ethical actions, rather than to the physical whereabouts, of persons.

Occasionally in the scrutiny of a client's affairs there comes to light some matter which outrages the sense of fairness of the public accountant. As an example, one was asked earlier in the year, by a client of many years standing, to define the taxable status of a proposed distribution. There had been included in the partnership agreement a provision for the establishment of a reserve for contingencies to be accumulated gradually out of the profits of each year until the total reached $100,000. Each of the five partners was to be charged with his profit-sharing percentage of the amount decided upon annually for the reserve. The agreement stated also that in the event of the death or other withdrawal of any partner, no part of any balance then remaining in the reserve account was to be returned to his estate or to him. The plan was followed for several years until the reserve account credit reached $100,000. No amount was ever charged to the account. At the 1945 year-end one of the partners withdrew and in due course received the balance of his *capital account*. Early in 1946 the *remaining* partners decided that the contingency reserve was no longer needed and arranged to divide the $100,000 among *themselves* in their new profit-sharing ratios. Hence the question to the public accountant of the taxable status of the distribution.

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There is here involved a question of fair dealing which greatly transcends a mere tax question. It is true that the partner who withdrew signed away, in the partnership agreement, his share in the contingent reserve, with the original thought no doubt that the reserve would be used for its undisclosed purpose. It is also obvious that the remaining members of the firm concluded to profit by the experience, and at the expense, of the retired partner by hastening to correct the situation.

It is this writer's thought that common decency, regardless of technical agreements, would dictate the return to the retired partner of his contribution to the unused contingency reserve. Also, that the public accountant should, before answering the tax question, insist that a full disclosure of what was about to occur be made by the partnership to the retired member and the resulting correspondence between the parties submitted for the accountant's inspection; the tax opinion should not be given until he is satisfied that everyone concerned is happy about the whole thing.

The case described is an unusual one but frequently an auditor notices acts which indicate distorted thinking and sharp practice. Instances are the ultimate possession without notice to the creditors of unclaimed balances and the proceeds of old outstanding cheques, inequitable distribution of expenses in cases where employees share in departmental profits, etc., etc. An editorial in the August, 1946, issue of the Journal of Accountancy included

the statement: "There are signs that the certified public accountant is becoming recognized as one whose knowledge and experience makes his advice worth getting, not only his advice on specific technical questions, but his opinion on matters of public policy". Why not carry this into everyday business conduct? Clients today have a high regard for public accountants and rely on them for guidance in financial and commercial matters. It should not be difficult to introduce ethical advice where needed. When unfair practices are encountered there is an opportunity for the practitioner, without assuming a "Better than Thou" attitude, to present the subject in such a manner that his client will see the error of his way and realize that the goodwill of his fellows is far more satisfying and valuable to him than the money immediately involved.

The answer to the question posed in the title of this brief article is "Yes", and if my brother (the client in the instances cited) resents the proffered advice to practice the Golden Rule, the earlier the practitioner and his client part company the better it will be for the peace of mind and self-respect of the public accountant.

Principles of Internal Control for Inventories

The basic principle of sound control is that movements of goods through the plant should be rigidly controlled by means of inventory and cost records. As far as is practical, stock should be delivered only upon proper requisitions or authorizations. Any release from accountability other than through proper delivery should be approved by an independent major executive.

Inventories and the Internal Auditor
by George A. Bricault and Cecil D. Marshall,
in N.A.C.A. Bulletin (Section One),
November 15, 1946.

Dividend Policies in View of Section 102 of the Internal Revenue Code

By Mark E. Richardson, C.P.A.

Introduction

IT seems axiomatic, under what we proudly term "the American way of life" that small businesses should be fostered in their desire to grow through the retention of earnings. It seems just as axiomatic that "big business" needs to protect itself against the low side of the business cycle and to plan for the future by providing for replacement and expansion of facilities.

Because of lack of understanding of the implications of Code section 102, the surtax imposed upon corporations which improperly accumulate surplus, many companies are "ham-strung" in their planning. The following is submitted in an effort to clarify this situation.

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Mr. Richardson is a graduate of Girard College in Philadelphia. He has written and spoken extensively on the subject of taxation. He is co-author of Montgomery's Federal Taxes on Corporations and is one of the lecturers at the New York University Institute on Federal Taxation. He is a member of both the Society's and the Institute's Committee on Federal Taxation.

This paper was presented by Mr. Richardson at a meeting in the Society's federal tax lecture series, held on December 19, 1946.

Is Section 102 New and What Is Its Purpose?

To many, problems in connection with the possible application of section 102 are not new. To others, possibly those whose business was not as profitable in past years as at present, all of the interest and discussion indicates something new or different in tax law.

The history of section 102 or provisions corresponding thereto goes back to the Revenue Act of 1917. In the 1917 and 1918 Acts, Congress provided for the tax treatment, for surtax purposes, of corporations which were formed or availed of to avoid surtax on shareholders, as partnerships. In other words, when it was determined that a corporation was so used, its income was considered as having been distributed ratably to its shareholders and includible by them for surtax purposes. Serious question arose as to the constitutionality of this treatment. Therefore, in the 1921 Act the section was rewritten and corresponded closely to the present section 102; the penal tax rate at that time being 25%. The rate was increased to 50% by the 1924 Act and remained at that high level until 1934 when it was reduced to the 25%-35% brackets; now 27½% and 38½%.

It is apparent, therefore, that the surtax upon corporations improperly accumulating surplus is an old and basic part of our tax law.

As to the purpose of this section: it is doubtful if any portion of tax law is clearer. The Code provision, section 102(a), imposes the penalty tax:

> ". . . upon the net income of every corporation . . . if such corporation, however created or organized, is formed or availed of for the purpose of preventing the imposition of the surtax upon its shareholders or the shareholders of any other corpora-

tion, through the medium of permitting earnings or profits to accumulate instead of being divided or distributed, . . ."

For the penalty surtax to apply, the corporation must be formed or availed of for the forbidden purpose. Accumulation of earnings or profits for some other purpose, if such other purpose can be convincingly demonstrated, is not prohibited and will not subject a corporation to the penalty tax.

Why Has This Section Become More Important Now?

During any period of demonstrable financial stress or uncertainty, a prudent business man is going to retain all available resources as a reserve or "hedge" against the future. During the war period and because of the uncertainties thereof, the Treasury was in no position to claim that any amount of retained earnings was unreasonable. This was even more true because the regular taxes, including the excess profits tax, were already making such a heavy cut into earnings. Moreover, if the company had war contracts subject to renegotiation the profits thereon were severely limited, and the remainder, after the heavy taxation had taken its toll, was generally in no danger of being challenged as an unreasonable accumulation. The end of the war terminated these uncertainties to a great extent.

A further consideration making section 102 more to be feared now than in pre-war days is the fact that for many years prior to 1940, corporations had not been able to build up any "cushion" or reserve against adversity. Statistics quoted by many speakers indicate that, for the 1936-1939 period, corporations in the aggregate reduced their surplus on the average of $400 million per year, either through losses or the excess of dividends over earnings. The same sources state that for 1940 there was an increase in aggregate surplus of between $700 million and $800 million. However, for the years 1941 through 1944, we are given to understand that the aggregate increase in corporate surplus averaged $4 billion per year.

If these figures are anywhere near accurate, and if they represent a general condition, it is obvious that many corporations may have accumulated all the surplus they can reasonably expect to show as needed reserves.

Do Dividends Have To Be Paid?

It is important to keep in mind that section 102 is not the same as an undistributed profits tax. There is no automatic taxation if earnings are not distributed. As stated in the opening paragraphs, there are many sound reasons for the retention of earnings and when these reasons really exist, and are demonstrable, earnings may be retained without tax detriment.

In many instances, particularly where an individual with large stockholdings contemplates sale of his shares, the penalty surtax may lose its effectiveness where sufficient earnings are retained to cause section 102 to apply. This is because the penalty surtax rate of 27½% on the first $100,000 of retained earnings is so low in comparison with individual tax rates that the transferring of income after section 102 tax into a capital gain may produce a lower combined tax than avoidance of section 102 tax by the distribution and payment of individual rates on a dividend. This circumstance may be clarified by an example.

> Suppose that Company A has earnings of $100,000 after taxes. Mr. X owns all the stock of Company A and the receipt of $100,000 in dividends in addition to his other income might net him less than $25,000 on such dividends. In addition, after the dividend the stock of Company A would be worth no more than at the beginning of the year.
>
> If Company A retains the $100,000 and is forced to pay $27,500 in section 102 surtax, it has remaining $72,500. If Mr. X sells his holdings of stock and is able to realize the increased value as a capital gain he would retain $54,375 of such increase.

Is There A "Safe" Percentage of Earnings Which Can be Distributed?

There is no particular percentage of earnings which under the law, regulations or decided cases can be considered as a "safe" amount of distribution. The so-called "70% Rule" is one that was established by the Bureau solely for the guidance of examining agents. (T. D. 4814, C.B. 1939-2, 108; as amended by T. D. 5398, C.B. 1944, 194.) Whether or not the corporation has distributed 70 per cent of its earnings, the question remains, under the statute, whether in fact the corporation was formed or availed of for the avoidance of surtax on its shareholders.

Where a consistent dividend policy, maintained over a period of years and providing for the distribution of a reasonable proportion of earnings can be shown, adherence to such a policy may, in many cases, be a reasonably safe procedure. Unfortunately, however, other factors change so materially from year to year that the consistency of the dividend policy may be overshadowed by changing conditions as to availability of equipment, volume or nature of business, change in type of product, etc.

Does the Law Put a Heavy Burden of Proof on the Taxpayer?

Because of the particular wording of section 102, the presumptive correctness which attaches to the findings of the Commissioner becomes even more burdensome than usual to overcome.

The Code language is as follows:

> CODE. . . . . Section 102. (b) The fact that any corporation is a mere holding or investment company shall be *prima facie evidence* of a purpose to avoid surtax upon shareholders.
>
> (c) The fact that the earnings or profits of a corporation are permitted to accumulate beyond the reasonable needs of the business shall be determinative of the purpose to avoid surtax upon shareholders unless the corporation by the *clear preponderance of the evidence* shall prove to the contrary.

By Statute, therefore, if the corporation is a mere holding or investment company it usually encounters an almost insurmountable obstacle. Similarly, if the Commissioner determines as a fact that earnings or profits were permitted to accumulate beyond the reasonable needs of the business, section 102(c) makes the burden of proof more difficult. The difficulty of overcoming the presumptions of section 102(b) and (c) is nowhere more clearly illustrated than in *Helvering* v. *Chicago Stock Yards Co.* (318 U. S. 693, rev'g 129 F. (2d) 937, which had vacated and remanded 41 B.T.A. 590.) At trial before the Board, the taxpayer had shown material business needs for the accumulation of surplus unrelated to the avoidance of surtax, but the Board held that, despite the forceful arguments presented, the taxpayer had failed to overcome the Treasury's determination. The First Circuit reversed the Board, holding that it improperly evaluated the needs of the business. The Supreme Court, however, reversed the First Circuit and held that the Board was free to conclude, from the evidence, that avoidance of surtax was the purpose of the accumulation.

Since the decision of the Supreme Court in the Dobson case (*Dobson* v. *Com'r,* 320 U. S. 489), which ruled forcibly upon the finality of findings of fact by the Tax Court, it is doubtful that appeal from a Tax Court decision in a section 102 case would be productive of anything but disillusionment.

As previously stated, the Code makes the fact that a corporation is a mere holding or investment company prima facie evidence of a purpose to avoid surtax. The meaning of these terms is therefore of great importance. The regulations provide:

> REGULATION. . . . A corporation having practically no activities except holding property, and collecting the income therefrom or investing there-

in, shall be considered a holding company within the meaning of section 102. If the activities further include, or consist substantially of, buying and selling stocks, securities, real estate, or other investment property (whether upon an outright or a marginal basis) so that the income is derived not only from the investment yield but also from profits upon market fluctuations, the corporation shall be considered an investment company within the meaning of section 102. (Sec. 29.102-2, Reg. 111.)

The meaning as set forth in the foregoing regulations has been approved and applied by the courts. (*United Business Corp.* v. *Com'r,* 62 F. (2d) 754, aff'g 19 B.T.A. 809; *Stanton Corp.,* 44 B.T.A. 56, aff'd 138 F. (2d) 512.) The interpretation by the regulations is so clear and logical that few questions arise thereunder.

It should be clearly understood that while the Code provision makes the existence as a mere holding or investment company prima facie evidence of the prohibited purpose, such provision does not preclude the taxpayer from submitting proof in rebuttal of the prima facie evidence.

What Are the Factors that Indicate that Earnings May Be Retained?

While the reasons for the accumulation of earnings will vary materially between companies, certain types or classes will be generally applicable. The regulations recognize certain of these general purposes.

> REGULATION. . . .Undistributed income is properly accumulated if retained for working capital needed by the business; or if invested in additions to plant reasonably required by the business; or if in accordance with contract obligations placed to the credit of a sinking fund for the purpose of retiring bonds issued by the corporation. . . . (Sec. 29.102-3, Reg. 111.)

Accumulation for specific reasons has been held decisive in numerous cases. These may be summarized as follows:

Earnings may properly be accumulated for modernization of plant and equipment, for advertising campaigns and for the development of new products. (*Lane Drug Co.,* T. C. Memo. Apr. 26, 1944.) The effect of the war on foreign business may well require the retention of earnings in the case of corporations doing business abroad. (*Dietze & Co., Inc.,* T. C. Memo. Nov. 23, 1942.) When earnings are retained for specific purposes, it is desirable for such use to be authorized by the directors, and made a matter of record by suitable minutes or otherwise at the time the decision is reached. Where feasible, it is further desirable to provide specific reserves in the accounts.

Where it is demonstrable that additional funds will be required for an anticipated increase in business, an accumulation of funds for this purpose is reasonable. (*Industrial Bankers Securities Corp.* v. *Higgins,* 104 F. (2d) 177; *Teeple Co.,* 47 B.T.A. 270 (A).) This is particularly true where it can be shown that the company has consistently followed the practice of paying for new plants and increased operational programs out of earnings. (*Flint Ink Co.,* B.T.A. Memo. July 14, 1942.)

Where a company sold exclusively to one customer, and the loss of that customer would necessitate removal of the company's plant and the undertaking of an expensive advertising campaign, and where increasing competition made the loss of the sole customer a possibility, retention of earnings as a reserve against possible needs was held to be reasonable. (*Teeple Co.,* 47 B.T.A. 270.)

If a corporation is threatened with legislation which is adverse to it or its industry, accumulation of earnings looking toward a change in business is reasonable. (*Seaboard Security Co.,* 38 B.T.A. 560.)

At the present time one of the major reasons for retention and accumulation of earnings might well be as a precau-

tion against a possible violent upswing in labor and raw material costs. This particular point has never been of apparent importance in any of the decided cases, but it is a vital consideration, right now, in many industries. The unsettled economic conditions during the war, which properly indicated the need of accumulation by many companies, are still proving to be almost as disturbing in attempting to resume peace-time activities in our industrial life.

What Are the Factors which Lead to Efforts to Impose Tax Under Section 102?

It is obvious, because of the statutory provisions, that a corporation which falls within the "mere holding or investment company" classification will always be subjected to close scrutiny relative to the possible application of surtax under section 102. There are many factors, however, which if existent in a particular case, will result in similar scrutiny even though the company is a bona fide operating business corncern. This is particularly true where the stock is closely held.

The most important adverse factor is probably that of loans to stockholders which remain unpaid for a long period of time. The regulations (Sec. 29.102-2) make particular reference to this situation. The existence of such loans has apparently been one of the major decisive criteria against taxpayers in many decided cases, notably *Helvering v. National Grocery Co.* (30 U. S. 282); *Wilson Bros. & Co. v. Com'r* (124 F. (2d) 606); and *Medical Arts Hospital of Dallas* (T. C. Memo., aff'd 141 F. (2d) 404). Large loans to stockholders are particularly damaging when made in proportions corresponding to stockholdings. (*Christmann Veneer & Lumber Co.,* T. C. Memo. May 16, 1945.)

Another important adverse factor is that of long-time investments in unrelated businesses or in listed securities. This is also commented upon in regulations. (Sec. 29.102-2, Reg. 111.)

Where the purpose of an accumulation of surplus is one which is primarily for the benefit of particular shareholders, as, for example, the acquisition of the company's own stock or the investment of funds in such manner as to produce income for the removal of certain stock restrictions, the accumulation has been held not to be reasonable. (*Helvering v. Chicago Stock Yards Co.,* 318 U. S. 693; *Trico Products Corp.,* 46 B.T.A. 346, aff'd 137 F. (2d) 424, cert. den. 320 U. S. 799.)

When Surtax Under Section 102 Applies, What Is the Income Which Is Taxed?

The basis for tax under Section 102 is the "undistributed section 102 net income." This figure is the "net income" with certain adjustments, as follows:

1. In the determination of net income, any capital loss carry-over or net operating loss deduction under section 23(s) is added back. These adjustments are necessary because of specific provisions relating to the same classifications which are provided for later.

2. The regular federal income taxes paid or accrued for the year are deducted. (Section 102(d)(1)(A).)

3. Contributions or gifts to donees described in section 23(o) are allowed to the extent previously not allowed because of the 5 per cent limitation. (Section 102(d)(1)(B).)

4. Losses from sales or exchanges of capital assets are allowed without limitation. (Section 102(d)(1)(C).)

5. The old "basic surtax credit" under section 27(b) is allowed as a credit with certain limitations. The important parts of the basic surtax credit are the "dividends paid" credit and the credit for an operating loss from the preceding taxable year. (Section 102(d)(2).)

It is important to recognize the difference between the regular net operating loss deduction (based upon a 2-year carry-over and 2-year carry-back of net operating losses) which is not allowed for section 102 purposes and the

operating loss portion of the basic surtax credit (based upon a 1-year carryover of the preceding year's operating loss) which is allowed in arriving at undistributed section 102 net income.

What Other Points Need Consideration?

Several other points of general interest need consideration in connection with section 102.

When consolidated returns are filed, any review of the reasonable needs of the business and any determination of tax is made on a consolidated basis. (Sec. 23.30(d), Reg. 104.) However, when consolidated returns are not filed, the determination is on the basis of the individual company. One unfavorable effect of this treatment is the inclusion in a parent company's income of the full amount of dividends received from a subsidiary, even though such dividends might represent the accumulation of earnings during many past years by such subsidiary. Furthermore, although the tax will be determined on a separate company basis, the available surplus of affiliated companies will be considered in connection with a review of the financial needs of any particular company.

The question sometimes arises as to whether dividends paid after the close of the taxable year can prevent the imposition of surtax under section 102. Such a procedure, under normal circumstances, is good evidence that there is no effort to accumulate earnings and no effort to avoid surtax on shareholders. However, if tax under section 102 should be imposed, dividends so paid are not a credit in determining "undistributed section 102 net income."

Generally speaking, case history indicates that unrealized losses are not given proper weight in the consideration of section 102 application. In *Helvering v. National Grocery Co.* (304 U. S. 282) the Supreme Court stated that unrealized capital losses were evidence to be considered, but rejected the argument that, in themselves, they justified a failure to distribute earnings. The Tax Court (formerly the Board of Tax Appeals) has given some weight to this condition in the case of an operating company (*Spitzner & Son, Inc.*, 37 B.T.A. 511), but has generally refused to consider the question seriously when a holding or investment company was involved (*Rands, Inc.*, 34 B.T.A. 1094; *Nipoch Corp.*, 36 B.T.A. 662). In one case (*Bloffer & Co. v. Com'r*, 103 F. (2d) 487, cert. den. 308 U.S. 576) surtax under section 102 was upheld even though the market value of the company's assets at the end of the year was less than its liabilities.

Efforts to avoid section 102 surtax sometimes include the declaration of stock dividends. Inasmuch as a nontaxable stock dividend is not and should not be deemed a distribution of profits, the declaration of such a dividend will not free a corporation from the tax imposed by section 102. A taxable stock dividend, on the other hand, serves to increase the surtax upon the stockholder, and it follows that a corporation which distributes its earnings in this form cannot be held to have been availed of for the purpose of avoiding surtaxes.

Conclusions

A review of the foregoing comments and cited cases indicates that section 102 does not need to be, and should not be, a detriment to sound business planning and to honest, sincere efforts toward expansion. However, the future of many small businesses rests in proper, understanding administration of this section. If the section is applied only where it was intended to be applied, the administering officials will be doing service to our economy. If it is used solely to collect more revenue, without consideration of the detrimental effects upon the future of our business enterprises, strong condemnation will be in order.

Partnership Tax Pointers

By J. K. Lasser and Harry Silverson

The predominance of the corporation in our economy, as an instrument of business and as as source of revenue, has given rise to a great abundance of tax law. So great have been the tax stakes involved that the best students in and out of the Treasury have applied themselves to the intricate and knotty tax problems identified with the corporate form. Out of the welter of experience and the clash of keen minds a large body of law has evolved. It illuminates the tax implications of corporate income, corporate distributions, corporate reorganizations, and corporate liquidations. The great concern with that dominant form of business activity, the corporation, has overshadowed the tax literature on the partnership.

The war years and wartime taxes had brought a new impetus to the use of the partnership form. Into the partnership form, evolved for relative simplicity, are today cast the most complex business organizations. New partnership agreements became complex documents loaded with tax significance. The limited partnership form was stretched and tortured to meet the complex needs of business that would ordinarily be more comfortable in corporate clothing.

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But the partnership is one of our little understood phases in Federal Tax controversies. The whole process of treating with partners and their firm is encumbered by a severe mixture of difficult decisions and complicated regulations. For example, consider the process of reorganizing partnerships through new capital contributions necessary to the conduct of the business. How you do it may often give you tax advantages. Here are two pointers:

Suppose you are called upon to make a contribution to a partnership. In order to do so you are compelled to sell securities that have appreciated substantially in value. You are thus faced with a capital gain that you do not wish to realize this year. Do this: contribute securities to the partnership. The partnership can then sell them in a year when you can offset it against losses. In any event, you will not have to report the gain until a future year.

You may contribute an asset to the partnership because you have a potential loss on it against which you have no offsetting gain. The effect of a partnership will be to defer the loss to a more propitious year. Thus the loss is more likely to be offset against gains or income.

How may you *step up* the cost basis of partnership assets? A recent case has interesting "reverse facts" inference. Two brothers were partners. One bought out the other for $16,000 less than his interest in the partnership. The Tax Court held that the brother continuing as proprietor purchased assets for $16,000 less than appeared on the books prior to purchase. The purchase was for a flat sum and so the basis of assets retained was scaled down *pro rata*. Among other things, this in-

cluded inventory, accounts receivable, etc., the continuing partner realizing $16,000 additional income upon sale of inventory and collection of accounts. Logically, this case suggests, that if the brother was bought out for $16,000 gain, rather than loss, we could step up the basis of similar assets on a *pro rata* basis.

If you really want to see what you know about partnership distributions, do this: try yourself out on the following self-analysis of your tax knowledge.

> Do you know the rules that follow partnership distributions of assets in kind? Do you know that you may suffer considerable change in your assumed cost basis of your assets?
>
> Are you aware of the methods of tax savings obtained through various systems of partnership distributions?
>
> You may have an arrangement to pay sums to a deceased partner at death, and you want to avoid having that taxed to the surviving partners.
>
> Certain partners may have put in property, rather than money for their partnership interest. Do you know how to use that for tax economy? And do you know how it may cause considerable tax loss to contributing partners?
>
> Do you know about tax savings that may come by sales by partners of partnership assets, rather than by sales by the partnership? Do you know that the methods of taxing sales of partnership property may vary considerably from what may be good accounting practice? Do you know the ways that may give you tax economy?

Haste and unawareness of the tax problems, the tax implications of the partnership, including the manner of getting into and out of it, have made for wide-spread tax waste. While much of the ground awaits illumination by the courts, there is considerable light available to those concerned with the partnership form.

We thought the subject so important that a couple of us set up, in simple tabulation, a set of rules to follow. This article contains our material on partnership distributions and sales. It consists of three working tools. They are intended to be check lists for ascertaining the result of a small phase of partnership operations. The tables in this article cover the tax effect of—

> The ordinary types of partnership distributions,
>
> The sale of assets by partnerships, and
>
> The sale of partnership property by a partner.

What Happens When Partnerships Divide Income

If You Distribute	*Rule*
Partnership profits, salary, or interest on capital accounts	All payments or income earned are treated as ordinary income to partner in year ending with close of partnership tax year—not that of individual. All items are treated as distribution of partnership profits.
Property in Kind	This gives no gain or loss on receipt. Gain or loss comes with sale of asset. See next point for possible aid in deferring gain on partial sale of assets received. This distribution may result in partners taking a cost basis for assets received far different from that of partnership. On receipt of this property you must allocate your total cost of partnership interest (based upon then market values) between assets received and those remaining in the partnership.

On liquidation of partnership, and there is a proportionate distribution of assets *in kind*. That is, you do *not* pay off partners in cash realized through disposal of assets	No gain or loss is recognized until disposal of the assets, even if they are worth more than partners' cost basis. That is not true in the liquidation of limited partnerships: One case allowed a loss to a limited partner whose right on dissolution was limited to the amount of his contribution. In another case, a loss was recognized where the partner received 80% in cash and 20% in property having a definite market value. In both cases, the Court pointed out that *real* losses were sustained. In ordinary liquidations of general partnerships, you only have gain or loss when property is sold by partners after the liquidation. Perhaps you may also regard first proceeds received as reducing your cost basis. If that is true, you have no gain until you recover cost. We do not know yet whether courts will require that or insist that you allocate proceeds to all assets received from partnership. That may be important if the assets received are not sold in one tax year. Authorities suggest you might avoid tax until there is full recovery of entire basis. See next point to find your cost.
On liquidation, but partnership first reduces all of its assets to cash	Gain is recognized if cash exceeds cost to partner. Regulations define cost to the partner to exclude from basis any amount of his accumulated income on which tax has not been paid. *If this is correct,* (and we have no cases upon it yet) you might have to eliminate tax-free income received during history of partnership (tax exempt interest, for example). Income during the year of the liquidation is taxed in your partnership return for such year and increases partners' basis by an equivalent amount.
On liquidation and there is an unequal or favored distribution of assets—for example, one partner gets all cash and the other gets all property	This is deemed a sale of partnership interest by the partner receiving cash. Payments here for profits resulting from appreciation of value of assets held by partnership may be ordinary income. Any other payments to partner may be a capital gain if they merely represent a distribution to settle for the value of his capital assets. The rules here are unsettled and it is advisable to check decisions for the latest principles.

What Happens in Sales by Partnership of Their Own Property

In Case of Sale of	*Rule*
Assets purchased by the partnership and subsequently sold by the partnership	The general rules for sale and exchange of property apply.

Assets which are part of the partnership capital contributed by any of the partners	To determine gain or loss in this sale note this: The basis of the assets in the hands of the partnership is the same as the basis to the individual partner making the contribution. The holding period dates back to the original date of acquisition by the partner making the contribution.

Note carefully the last rule. Most partnership agreements give a partner full credit for market value of partnership property contributed. That can give considerable chance for tax loss or tax control. Regulations provide that the gain or loss, based upon the contributed partners basis is to be prorated on the basis of the gain or loss ratios in the partnership agreement. That is assumed to mean that the partner who contributed the property takes the gain or loss due to the distortion in the basis. Here is what might happen in case A and B agreed to contribute $100,000 each to a partnership. A put in cash and B put in securities costing him $40,000 but worth $100,000. Assume that in 1946, there was a sale of securities and the business earned $50,000. A and B would both report $25,000 of business income and the following capital gain or loss on the sale of the securities.

	If the securities sold for			
	$110,000	**$100,000**	**$80,000**	**$30,000**
Total gain or loss is....	+$70,000	+$60,000	+$40,000	—$10,000
A would report				
Gain of	5,000			
Loss of			10,000	35,000
B would report				
Gain of	65,000	60,000	50,000	25,000

If B put in securities costing him $150,000, the following capital gain and loss would be reported on the sale of the securities—

	If the securities sold for				
	$200,000	**$160,000**	**$120,000**	**$100,000**	**$70,000**
Total gain or loss is	+$50,000	+$10,000	—$30,000	—$50,000	—$80,000
A would report					
Gain of	50,000	30,000	10,000	—0—	
Loss of					15,000
B would report					
Loss of	—0—	20,000	40,000	50,000	65,000

The same rule above covers depreciation and depletion allowances. Regulations require that depreciation be computed on the same basis as gain or loss to the partner, i. e. based upon the contributing partners' cost basis. Then they indicate—

If cost basis is	**Depreciation or Depletion is**
Less than market value................................	Limited to cost.
More than market value................................	Based on cost.

What Happens in Sales by Partner of Partnership Property

In Case of Sale by	*Rule*
If partnership assets distributed in kind to the individual partners	If partnership assets are distributed in kind to partners, the cost of the distributed property is complicated. You apportion the partners own total cost of his partnership interest to the— Property received upon the distribution in kind, *and* Property remaining in the partnership. Both are valued at market value at the time of distribution.

Because of this rule, it may sometimes be highly advantageous for a partnership to distribute assets to partners who then may sell them. The partners basis for the assets may be greater or less than the partnership. That depends upon the values of the assets retained as well as those distributed.

If partnership property is purchased by one of the partners

No matter what form it may take, this is in reality nothing more than one partner buying the interest of his partner in the property. In effect the property in question is liquidated in kind pro rata among the partners. Then one partner buys the undivided interest of the other partner. The gain or loss to the partner who sells his undivided interest is measured by the difference between the cost of his interest in the property and the proceeds from the sale of his interest. The purchasing partner does not realize gain or loss upon the liquidation of an undivided interest in the property in kind or the purchase of the other undivided interest in the property.

Over-All Objectives of Internal Auditing

The over-all objectives an be broken down into major components or broad functions of internal auditing. These broad functions have been set down in various ways but the following classification appears substantially to cover the problem.

(a) COMPLIANCE—There is the function which has to do with ascertaining the extent to which there is compliance with established company rules, procedures and policies.

(b) VERIFICATION—This second function emphasizes the objective of establishing the reliability of accounting and statistical data which are developed and reflected directly or indirectly in the company's financial statements.

(c) ANALYSIS—This third function relates to the analytical activities which are carried on in connection with, or supplementary to, the verification activities.

(d) PROTECTIVE—This function emphasizes the objective of ascertaining whether company assets are protected in both a physical and financial sense, including the prevention of fraud and error and maintenance of normal efficiency.

(e) APPRAISAL—This is the function which more than any other emphasizes the constructive side of internal auditing and which distinguishes modern internal auditing from the older and more narrow concepts. It deals with methods, procedures, people and policies. Its keynote is constructive criticism—a survey of existing procedures and operations with identification of actual or potential defects, if any, and recommendations as to improvement. This appraisal function relates most directly to accounting matters where the training of the internal auditor involves a greater range of knowledge and responsibility. It relates, also, however, to non-accounting matters which come to the attention of the internal auditor in the course of his examinations, although here, of course, there is a lesser range of knowledge and responsibility.

From the Research Program of the Institute of Internal Auditors
The Internal Auditor, December, 1946.

Practical Sampling for Auditors

By Leo Herbert, C.P.A.

In the course of an audit, an auditor may analyze in detail each item in the books. However, in most instances, to arrive at a conclusive opinion in regard to the records, it is unnecessary to collect complete information on each item with which the auditor deals.

To overcome the necessity of checking each item in every investigation, accountants and auditors have employed the method of "test checking" or "sampling." From the test check or sample, a relatively small part of the records, the auditor draws a conclusion as to the general accuracy of the accounting details.

To appreciate the auditor's problems of sampling, one must know about sampling theory as applied to data which an accountant will probably encounter. Sampling theory is basically related both to the theory of probability and to the likelihood of errors. Whenever each item chosen has the same probability of being chosen as any other item in the group, the relationship between the items may be worked out to a precise mathematical point. This may be illustrated by the use of dice; each number on a die has the same chance of turning up as any of the other five numbers; or in flipping a nickel, heads has just as much chance of coming up as tails. Many such mathematical relations were worked out in games of chance long before the idea ever developed of applying probability techniques to statistical analysis.

Random sampling is often used when each item in the problem is in equal proportion to all other items. Auditors seldom use a random sample, since most of the data with which they deal are not of the type which justify using a random sample.

Whenever heterogeneous data, such as those encountered by accountants, are used the method of stratified sampling is often employed. This is illustrated by the analysis of accounts receivable. Frequently an auditor is satisfied with a 100 per cent sample of all accounts above $1,000; a 50 per cent sample of accounts between $500 and $1,000; a 25 per cent sample of accounts between $100 and $500; and a 5 per cent sample of those under $100. All accounts receivable are broken down into subgroups before the sample is taken.

When a sample is selected by design it is often called "purposive." A purposive sample is employed when certain characteristics of the total of the item are already known and the sample is taken to agree with the known facts. A good illustration of a purposive sample in auditing is the usual procedure of examining the first and last months of a period, because the auditor knows the chance for uncovering fraud or error is greatest in those two months.

The theory behind sampling assumes that a small number of items will show the same characteristics as the whole. Only when certain basic rules and procedures are followed, does the sample

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thus agree with the whole. The major considerations for any sample are:

1. The sample must be representative.
2. The sample must be adequate.
3. The sample must show stability.

A sample is representative when it shows the same characteristics as the whole mass of data in the problem. Many statistical inferences from samples are incorrect because the sample does not represent a true picture of all items.

A sample is adequate when (1) each item has the same chance of inclusion as all other items, and (2) enough items are included to show the same results in successive samples.

A sample is stable when the results of a sample will continue to remain the same no matter what size the sample may be.

Other considerations which must be heeded are: the relevancy of the sample to the problem, the use of homogeneous data in the sample, and the accuracy of the work in gathering and compiling the sample.

There are limitations on the use of the sample in accounting investigations, however. These limitations may be due to the data themselves or to the person who takes the sample. For instance, a sample may be biased because a particular person takes it, or the sample itself may have a bias which is not readily visible (e.g., the observation may be taken from the most available data instead of obtaining data which are representative). Both types of bias may be present.

Conditions of sampling, especially in auditing, rarely approach the theoretically perfect state in which samples show exact results. However, it is not necessary to have this theoretical perfection in order to obtain benefits from a sample, since a sample which is adequate and representative will give results useful in most practical auditing situations.

There are two major types of problems involved in practical auditing samples: (1) What data are necessary for the study, and how large a sample is necessary to determine whether the data will show what is needed? This, of course, means determining the minimum number necessary for the observation, or the amount above which one need not go to get dependable results. (2) How is it possible to determine whether the sample is adequate and representative?

There are many cases in accounting-statistical analysis in which it is possible to use all the information available and still not have enough data to arrive at a correct conclusion regarding the problem.

The problem of determining how many observations are absolutely necessary comes under the heading of forecasting. The problem of forecasting the size of a sample, unless the problem has been done many times before, usually is a matter of personal judgment. The auditor arbitrarily determines a figure which he considers to be sufficient in the light of his past experience. Before the work is complete, the adequacy of the sample may be checked by mathematical or other methods. For example, if, in auditing accounts receivable, the first confirmation statement returned had an error in it, but the next 25 did not, about the only conclusion at that point would be that there was at least one error in the accounts receivable. If, however, after receiving 500 returned confirmations, there continues to be an error in one of each 25 returned, the auditor could infer that there was an error in 4 per cent of the accounts receivable, and would perhaps check the accounts more thoroughly.

The amount of time and money saved through accurately predetermining the number of observations is easily recognizable. To underestimate the number in the sample would be a worse mistake than to overestimate. When the number has been overestimated, the data can be used; whereas if it has been underestimated, the material is value-

less for statistical study and may prove embarrassing to the auditing firm.

After the results from the sample begin to come in, it is possible from these results to determine whether any stability exists in the answers to the questions. Probably the most familiar method of determining when the answers begin to become stable is by separating the returns into random groups. When, through additional returns for each group, the answers in each group tend to remain the same percentage of the total of the group, then stability may be said to exist.

Mathematical methods have also been devised to determine the size of the sample. Theodore H. Brown of Harvard has devised a table showing the size of the sample when the percentage of permissible error is known. Several limitations exist in this type of table, however, since it works on the principle of probability and many accounting samples do not conform entirely with the laws of probability.

As has been mentioned, the size of the sample, among other things, determines the cost of sampling. Size is no criterion of value, however. The Literary Digest Poll of 1936 was large but contained so much error it was worthless. There is then this principle: that the sub-samples must stand alone and not be dependent upon the major sample. The major sample may be large but not contain relevant data or sufficient data for the sub-sample. The size of the sample is determined by the amount of allowable error in the sample.

Difficulties exist in sampling to a greater extent in business or social data than in physical data. Human limitations exist in the sampling of this type of material. Instead of taking a random sample, it is usually better to break the sample down into subgroups, based on some known facts about the whole, and then take a random sample of this stratified sample. This step is taken so that a correct proportion of the universe will be taken and is known as getting "proportionality in the sample."

L. O. Brown makes the statement: ". . . it was shown that an adequate sample has two characteristics: (1) reliability, and (2) proportionality. In planning a sample every effort is made to obtain both of these characteristics."[1] Problems of finding the reliability and proportionality of the sample and remedying any obvious defects may be major considerations.

Unless an engagement is very small, or a need exists for very great accuracy, time and expense do not allow the auditor to determine by examination of each item in the audit that the transactions and accounts are correct. Yet the auditor wishes to be certain the chances are very high that he has not overlooked an error. As has been stated in the above section on the theory of sampling, it is usually up to the person making the audit to determine which section of the audit may contain the most errors and the number of errors possible in that section.

Testing by sampling in an audit involves the separation of items into homogeneous groups. That is, the representativeness of the sample could not be determined very well if one were testing the type of inventories and the footings of the inventory sheets all in the same sample.

The major groups to be tested by the auditor come under the following headings: accounts receivable balances, accounts payable balances, inventory types, inventory footings, purchase vouchers, cash disbursements, payrolls, cash book postings, and voucher register footings. Whether the items will be tested completely or only in part depends entirely upon the possibility of error existing in each of the various classifications. The amount of error which can be readily determined de-

[1] Brown, Lyndon O., *Market Research and Analysis.* (New York; Ronald Press Company, 1937), p. 310.

pends upon the amount of internal control and the skill of the auditor.

When sampling or test-checking during an audit, the auditor is trying to determine whether there are errors in the books, without examining each transaction. If it were known that there were no errors, the auditor could certify the company's statements without taking the time necessary to go through the details of the company's books. However, neither he nor the company knows how many errors there are in the records; that is one of the reasons why he has been called to audit the books and give an independent opinion as to whether the records are kept accurately. When an auditor needs to make a detailed examination of every transaction, costs run very high in the large concerns. If the auditor can convince himself that the chance for error is very slight, it is not necessary to investigate every transaction.

Sampling techniques in auditing attempt to determine the probability of locating errors in the records. When there are only two items to be tested, and one of them has an error in it, there is a fifty-fifty chance that the error will be detected if only one item is investigated. Stated differently, there is one chance in two that the error will be located. When there are a hundred items and two errors, there is one chance in fifty that one of the errors will be located if one item of the total is investigated.

The assumed conditions are true only if the item that is being investigated is selected on a random basis. If the person knew that there were a hundred items to be investigated and he also knew that the error was located in a group of ten items, then when he selected one of the ten, his chances of locating the error would be one in ten rather than one in a hundred.

When an auditor selects footings by months rather than by the number of footings, he is violating the principle of random selection, as he is not selecting a group of random items to be checked. The probability of finding one error in a year's footings is much greater when one-third of the footings are tested than when footings for four separate months are tested. The same principle is true in testing accounts receivable. When there are 3,000 items, it is much better in a 10 per cent sample to select every tenth account than to select the accounts under A, under H, and under R, which would constitute approximately 10 per cent of the total.

Assumed Number of False Items in Group	Most Economical Random Sample (Approximately)	Probability of Encountering at Least One False Item (Approx.)
Over 40	8%	Over 95%
Over 30	10	Over 95
Over 20	15	Over 95
Over 15	20	Over 95
Over 10	22	Over 90
Over 9	24	Over 90
Over 8	26	Over 90
Over 7	28	Over 90
Over 6	30	Over 85
Over 5	35	Over 85
Over 4	40	Over 85
Over 3	45	Over 85
Over 2	50	Over 75

The first problem, then, in test-checking in an audit is to determine the possible errors located in each of the different items to be tested. How many errors are there likely to be in the accounts receivable? How many errors are to be expected in the voucher register footings; the purchase vouchers; the cash disbursements; or any of the other items to be tested? When the expected number of errors is determined, then if there is to be a reasonable expectation of finding one of those errors, the table above may be em-

ployed as a guide in the size of the sample to take.[2]

The percentages shown have been computed by determining the area under the normal curve, and may reasonably be expected to be accurate when the items being tested form a normal distribution. Usually in testing inventories or accounts receivable or payable, the very large accounts are separated and examined thoroughly whereas the smaller accounts are test-checked. This method eliminates any possibility of overlooking a gross error. If no errors are found in the sample, the probability is very high that there are no errors in the type of items being tested.

While test-checking by public accountants is a recognized method, very little theoretical study has been given to sampling for public accountants. If an auditor expects to form an opinion based on information devised from samples, it may be necessary in the future for him to be able to prove the reliability of the sample selected. To do this might require that he demonstrate its statistical characteristics.

[2] The above table was taken from Robert H. Prytherch, "How Much Test Checking Is Enough," *Journal of Accountancy,* Vol. 74, No. 6 (December, 1942), pp. 525-530. The original material from which the table was formed is found in Lewis A. Carman's "The Efficacy of Tests," "Test-Checking Subjected to Mathematical Analysis—Constructive Article on New Subject." *American Accountant,* December, 1933, pp. 360-366. The preceding two articles are probably the best technical articles on test-checking which have been written in the last ten years.

Logic in Accounting

What many of the critics of accounting do not realize is that there is a philosophical basis in accounting which perhaps has not yet been fully explored but which, with further concentrated study of its basic conventions and its social implications, is gradually being manifested. They do not realize that the study of accounting, under a modern presentation, constitutes an exercise in logic; that "accounting procedure in all its aspects is but the practical exposition of an essential unity in accounting principles"; and that the successful study of accounting provides a development of the capacity for clear and logical thought. They do not recognize that there is involved in the study and practice of accounting a search for the best means of interpretation and recording of events, and that in the course of this search a mental discipline is imposed which can with advantage be applied in other spheres of mental activity; that the capacity for precise and critical thought and observation which accounting requires is one of the features the development of which should be an important objective of any sound educational system.

"The Teaching of Accountancy," by L. Goldberg, A.I.C.A.,
The Australian Accountant; September, 1946.

Is a Balance Necessary?

By Lewis Gluick, C.P.A.

ONE of the first things students of bookkeeping are properly taught is that a trial balance with equal debits and credits is not necessarily correct. Close attention is invited to the word "trial"; and a facetious instructor may even go so far as to compare it to an amputee using his cork leg for the first time. After that disillusion is quick. The student, and later the bookkeeper, is required to obtain a balance, and may be penalized for failure to do so.

Auditing texts quite properly point out the futility of spending hours or even days in looking for small differences. However, I will never forget hearing the venerable Montgomery say, at a meeting of our Society at least ten years ago, that he "hoped to live long enough to see a Balance Sheet that did not balance." Divorced from its context, that sounds like rank heresy. Yet as part of a talk on the over-emphasis on arithmetic while disregarding principles, it was entirely in order. I doubt if the good Colonel will live that long. But I for one want to give an affirmative answer to the question which titles this article. First, I want to concede the cogency of all the arguments against being too meticulous. Second, I want to go back to a case I assisted on over a quarter of a century ago. It was a bankruptcy, with the books brought to the office. Our good boss gave me a subsidiary ledger with instructions to take off a schedule of open balances; he gave the general ledger to a colleague of mine. After a while the latter handed over a trial balance and the boss, after less than a minute, exclaimed, "There's something radically wrong here; it balances!" And by gosh, when our audit was finished, we had found plenty of fraud! My boss' experience in bankruptcy audits had taught him that a balance might be suspicious, although the absence of a balance was not proof of innocence.

However, my own experience has shown me that the absence of a balance usually means trouble, though not necessarily fraud. And many friends confirm this. A member of this Society delights in recounting an experience of his many years ago. He was sent out of town, solo, on a big audit. Working papers of previous years showed a small general ledger trial balance error. Also, that the old general ledger bookkeeper had a big job, worked hard, and did not have time to hunt minutely for the difference. Our young auditor was full of youthful ambition. Failing to get the client's permission to look for the difference, he worked overtime without charging it on the time sheet. In the end he uncovered an embezzlement of nearly $10,000 running back several years. The old bookkeeper had relied on the failure of the auditors to make complete check of all ledger postings.

Coming down to date, I have a client who keeps her own books and, in general, does a good job. When a proprietor does the bookkeeping, internal check against fraud is automatic. But she developed an error in the bank account, which persisted. Very reluctantly she agreed to let me search for it. At the end of the first half day she was a bit sarcastic over the two errors discovered, aggregating 6¢. But an hour later I hit an error of nearly $200 and in the end had an aggregate of errors of approximately five times that. They very nearly offset each other, yet, when spread on the books, a considerable difference, taxwise, was evident, for the

Lewis Gluick has been a member of our Society since 1924. He is now engaged in practice in Long Beach, California. He is best known as the Shoptalker, under which name he has been writing since 1928.

errors were not equally income and expense. Peculiarly, her errors, undetected, would have favored the Collector.

Then there was a big consolidated return I worked on many years ago. There were 13 companies, and practically all had running accounts with all the others. Reconciliation up to a certain point was not difficult; then we hit a stubborn difference between two companies; and not very big. Ours was a tax engagement; it seemed futile to spend more time on the one account, and we (that is, the men on the job) said so. Our principal said "Find it!" So, with much effort, we did. The result was zero, taxwise. But we uncovered an ingenious scheme whereby one subsidiary was "milking" another, to the benefit of a profit-sharing manager, all unknown to the top management. Our boss had no difficulty in getting extra compensation, and much praise to boot. He had gambled successfully, on the premise that *a balance is necessary*.

But there is another aspect to the proving of a balance that to me is most important. That is psychological. It is a satisfaction to find a stubborn error, to prove that something is wrong, and to demonstrate that you are the bright lad who can find it. That builds morale. A balance sheet, no matter how carefully audited is, in essence, an expression of opinion. But a trial balance that agrees, a bank statement that reconciles to the last cent, a statement of application of funds that demonstrates where the profits have gone, is susceptible of mathematical proof, and not subject to argument. It gives me a lift.

All we need to do is to retain perspective. We must never forget that a trial balance does not prove the accounts therein correct; and also remember that, lacking a balance, we can never prove anything. We must get a balance between the cost of obtaining the balance and the value thereof when we have it.

But balance we must,
Or our audit's a bust,
And this be our motto,
"In no one we trust".

Rummage Sale

Men folks are inclined to smile a bit over the hectic ramifications of a first-class rummage sale. When an organization decides it needs money for some good purpose, there's a reason why women ejaculate "Rummage Sale" almost in unison. That reason is a good sound democratic one—the basis of our nation's growth and a standard of living that allows a workman the same benefits of modern science as a capitalist. There's one indisputable, unanswerable, over-all argument in favor of rummage sales that a woman can use to silence her skeptical or derogatory mate.

The fact is this: rummage sales are highly profitable. When a woman says "Our expenses were $14; our net profit was $276.85" many a man runs his eye down his own balance sheet. "You see," the Little Lady says to her dazed mate, "we operate on a very safe business principle. We get all our things for nothing; we have no real selling expense. All we pay is rent and the janitor. We tried lots of ways of making money but we've never found anything to equal a rummage sale."

—"Pepper and Salt"
The Wall Street Journal, January 7, 1947

PROFESSIONAL COMMENT

By EMANUEL SAXE, C.P.A.

Accounting Requirements of the Veterans Administration

A Novel Contention Regarding the Cash Basis of Accounting

An honorably discharged veteran, whose civilian occupation for about three years prior to his entry into the Armed Forces of the United States had been that of auditor, presented a claim to the Veterans Administration for a monthly allowance of $100 pursuant to the terms of Section 902 (b) of the Servicemen's Readjustment Act of 1944:

> "Upon application by the veteran showing, in accordance with rules prescribed by the Administrator, that he has been fully engaged in such self-employment and that his net earnings in a trade, business, profession, or vocation, have been less than $100 in the previous calendar month, the veteran shall be entitled to receive, subject to the limitations of this title as to time and amount, the difference (adjusted to the next highest multiple of $1), between $100 and his net earnings for such month."

In the preceding month, such an allowance had been granted to him by the examiner since, by applying the veteran's "Gross cash sales less cash purchases" method of computing income, no excess of income had resulted. This month, the agency examiner rejected the method previously used and substituted a computed value of the cost of goods sold based upon a stated gross profit percentage.

The veteran appealed this decision and contended for the continued use of the "gross cash sales less cash purchases" method; also, that the examiner's computation based on the gross profit method was "not compatible with . . . the cash basis method as used in accepted accounting procedure." In this argument he was supported at the hearing by the Industrial Commissioner. However, the latter admitted that this method might produce an inequitable result in cases like this if profits were continually plowed back into the business in the form of purchases of goods. The Commissioner's computations resulted in his disallowance of the current month's purchases as representing in the entirety an unreasonable increase in inventory beyond the reasonable needs of the business; however, he advocated the continuance of the veteran's method of income determination subject to this limitation.

The reviewing Agent sustained the previous decision of the Referee, which in turn upheld the local office determination. He characterized the contention of the Industrial Commissioner as not practical and not applicable under all circumstances or to all types of business. He approved the examiner's decision as a realistic solution which would not work any hardship upon the veterans. (Case RA-S-185-46.)

To the writer, the most interesting and astonishing aspect of the entire proceeding is the fact that nowhere at all in the lengthy opinion does any reference appear to that important condition precedent to the use of the cash basis of accounting, as exemplified in income tax practice, namely, that the method *cannot* be used whenever the purchase and sale of merchandise is an income producing factor and inventories are therefore necessary to compute income accurately.

* * *

A Similar Case

A variation of the same proposition was recently encountered in the case of another veterans (RA-S-243-46) who

presented a claim for a similar allowance on the basis of the following monthly figures: Gross sales income—$2,588.82. Expenses: Rent, light, telephone, wages, and insurance—$135.97; Merchandise for resale—$2,859.81; or a total of $2,995.78.

The veteran conceded that his gross profit was about 25% of the sales. The local office determined that his cost of goods sold was, therefore, $1,941.62 and that after payment of operating expenses of $135.97, his net profit was $511.23.

The veteran contended, *inter alia,* that he should receive the allowance provided under Section 902(b) of the Act, since the net cash paid out exceeded the net cash income for the month.

The reviewing Agent held that,

> "where no undue burden, inequity or abuse would result, 'costs of goods purchased' are not properly an 'expense' of operations; that 'cost of goods sold' should be deducted from 'gross cash sales' to determine . . . 'gross profit'; that 'gross profit' or 'cost of goods sold' may legitimately be determined by application of the 'mark-up' method, in the absence of complete figures; and that 'net earnings' may then be determined by subtracting allowable items of 'expense'. * * *"

* * *

Audit Requirements of the Veterans Administration

The regulations (Paragraph 14 (d) of V. A. Instruction No. 1) provide,

> "Each self-employed individual shall maintain such records as are necessary for a determination of his net earnings. Such records shall reflect income received and expenses paid, and shall be open to inspection or audit by an authorized agency representative, or of the Veterans Administration."

In pursuance of this regulation, a self-employed veteran may be required to produce all bills, receipts, invoices, statements, etc., to substantiate corresponding ledger entries. In another recent case (RA-S-139-46) when such a veteran failed to substantiate by receipts, cancelled checks, or other documents, a recorded expenditure of $915.57, the expenditure was properly disallowed, as it was impossible to audit the veteran's records under the foregoing regulation.

* * *

Budgets for Cost Control

This article appearing in Section One of the November 1, 1946, issue of the N.A.C.A. Bulletin, was written by David B. Caminez, who is assistant controller at the Hyatt Bearings Division of the General Motors Corp. Mr. Caminez is a C.P.A. of New York State, as well as a member of its Bar.

In order to obtain a high standard of living, it is the author's contention that we should concentrate upon the attainment of high productivity. By this idea he does not mean a speed-up or a sweat shop but, on the contrary, a fair day's work according to reasonable standards of efficiency, using to the best advantage the available facilities, tools, and material. The author says that it is the objective of cost control "to get the greatest amount of production from a given amount of manpower, materials and facilities." The way to achieve this objective, he says, is by having a budget established in advance and reasonable standards which are possible of accomplishment. According to the author, budgets for cost control should be considered under three subdivisions: (1) The profit and loss budget. (2) Control of manufacturing costs. (3) Physical unit budgets for implementing factory cost control.

No budget may be a substitute for good planning; and the profit and loss budget is not the plan but the result of planned operations. The first step in its compilation consists of the preparation of a sales forecast. On the basis thereof, the next step is the establishment of a production schedule based upon the actual opening inventory and the desired closing inventory. Next, we

should establish budgets and determine the elements of factory costs under each of the three principal cost classifications, namely—productive material, productive labor and manufacturing expense.

The next step after completing the manufacturing cost budget is to arrange for and control the commercial expense accounts. These ought to be controlled as effectively as manufacturing costs because they are as important a part of the sales dollar outlay. It should be borne in mind that they, too, contain both fixed and variable elements.

After the budget has been prepared, it is necessary to see to it that management receives current reports of budgetary performance; otherwise, the budget ceases to be of any value as an operating tool.

In this connection, the author suggests the use of a daily plant report, which he describes in detail, and he also indicates the method of collecting the daily information necessary for the preparation of this report. Departmental reports are prepared every ten days, in the same form and manner as in the case of the daily plant reports. Foreman assistance reports and physical unit budgets are also described. These latter, says the author,

> "make it possible to give the foreman a 'bill of material' of the people and things required to accomplish a production schedule. . . . With a 'bill of material' available, the foreman or supervisor need only to 'count noses' to determine if he is meeting his budget as far as personnel is concerned. He also may check off the indirect materials and tools he has requisitioned against a list."

The set-up of industry in this postwar period imposes many new and important problems. High unit profit margins are a thing of the past and profitable results from operations must be achieved, says the atuhor, on the basis of high volume, low unit cost, narrow unit profit margins, and high turnover of investment. The key to these, says Mr. Caminez, is in the greatest production yield from a given quantity of manpower, materials, tools, equipment and working capital and, in this connection, intelligent cost control plays a great and important part. Indeed, management will have to rely more than ever on the cost accountant in the difficult days ahead.

* * *

Inventories and the Internal Auditor

George A. Bricault and Cecil D. Marshall have written an excellent paper on this subject, which appeared in the N.A.C.A. Bulletin (Section One) for November 15, 1946. It

> "describes the procedures for the planning, organization and conduct of a complete physical inventory with particular emphasis on the part played by the internal auditor, and describes the steps in internal auditing needed in those cases where a book inventory, verified by continuous check, is substituted for a complete physical inventory or the physical inventory is taken at some date other than at the end of the fiscal year."

The functions of the executive inventory supervisor, of the physical phase inventory supervisors, and of the accounting phase inventory supervisors are explained. The instructions for the various stages of inventory taking, and inventory control are discussed. The contents of the internal auditor's report on inventory are outlined. The article is well worth thorough study.

* * *

Airline Accounting

C. G. Adams, the Secretary-Treasurer of Braniff Airways, Inc., Dallas, Texas, recently presented the essentials of the uniform system of accounts as developed by a committee established by the airlines in collaboration with representatives of the Civil Aeronautics Board, and effective since January

1, 1942. It appeared in Section One of the November 15, 1946, N.A.C.A. Bulletin.

Besides presenting a reproduction of the prescribed uniform balance sheet and profit and loss account schedules, the article explains the methods involved in the operation of the Interline Clearing House, the records required in accounting for air mail revenue, suitable methods of payroll preparation, control of engine repair costs, etc.

As the author says, "In no other industry are the ordinary everyday operations so dependent upon proper accounting. . . . In the air transport industry . . . the failure of flight equipment must be prevented, and to assure this all major components of such equipment are removed from service and thoroughly examined periodically."

Postwar Practice in Accounting for Emergency Facilities

Section Three of the November 15, 1946, issue of the N.A.C.A. Bulletin contains a 26 page study (Research Series No. 8) under the foregoing title.

The 1945 published annual reports of leading American corporations were studied by the N.A.C.A. research staff, under the supervision of their Committee On Research, to determine the practices followed in accounting for emergency facilities.

The study is entirely factual and is "published in the belief that information in the practice followed in this area will be of current interest and will contribute to later studies in the broad field concerned with the spreading of costs over periods of time."

An Interesting Problem

Lewis Gluick sent in the following problem for consideration. Interested readers are invited to submit their views as to an appropriate method of handling the matter.

> "A corporation has for a number of years *consistently* included a pie chart in its report to stockholders and employees. The 'pie' represented sales, and the wedges represent costs, expenses, taxes, etc., with an ever narrowing sliver for dividends. The basic 'pies' were also scaled to represent sales totals. That is, a larger pie for larger sales. But for 1946 there is a loss.
>
> "*Question:* How can a loss be represented on a pie chart? I can find nothing in any available book on statistics. The corporation is unwilling to change to bar charts, to which the report readers are unaccustomed. The change would also involve considerable work to make comparisons for all preceding years.
>
> "I did figure out a way, whereby the total of costs and expenses made one circle, and the sales an inner circle, with wedges as usual. On a very large scale, it worked; but when reduced to the size required for a printed report the circles could not be distinguished."

BOOK REVIEWS

Advanced Accounting,

by E. I. Fjeld and Lawrence W. Sherritt. THE RONALD PRESS COMPANY, New York, 1946. VII + 490 pages. $4.50.

The authors, both members of the accounting department of the School of Business and Civic Administration, The City College of New York, state in the preface that they have written this volume on Advanced Accounting "for the use of undergraduates in their fourth semester of accounting instruction. Its primary objective is to apply the principles of corporation accounting to specific situations".

In carrying out this plan each chapter presents a general introduction to the topic including, where applicable, a discussion in non-technical language of the legal and business background. The authors then present the accounting treatment with explanatory journal entries, and the chapter is completed with lengthy illustrative problems and comments which apply the principles previously outlined.

The technique outlined above will be most helpful to those preparing for the C.P.A. examination. The material is presented completely, but in a condensed manner which allows rapid review. By reviewing the illustrative problems in detail, the student will reacquaint himself without difficulty with the required theory.

However, while good for the advanced student, this volume may be difficult for the ordinary college student since he is not introduced to the topic in gradual stages but is almost immediately launched into an all inclusive problem which he may find confusing. The authors have, I believe, partially solved this by preparing many correlated problems on "the theory that the best way to give the student a real mastery of accounting and confidence in the ability to apply what he knows is through carefully planned intensive practice".

This edition consists of 15 chapters covering 401 pages, followed by 83 pages of problems arranged in groups coinciding with the chapters and by a 5 page index. The chapters are devoted to Installment Sales, Consignments, Agency and Branch Accounting, Foreign Exchange, Foreign Branches, 5 chapters on Consolidated Balance Sheets and one on Consolidated Profit and Loss Statements, Statement of Affairs, Receivership Accounting, Realization and Liquidation Statements and Corporate Reorganizations. Since this is an advanced accounting book, the authors have not discussed topics usually appearing in elementary and intermediate texts, such as current assets, fixed assets and depreciation, deferred charges, liabilities, partnership accounts, corporate accounts, etc.

The authors have, where controversial material is presented, documented their book by reference to published stockholders' reports, to the Journal of Accountancy, and to other accounting texts.

The authors recommend that the term "Consolidation Premium" be used where, upon the preparation of a consolidated balance sheet, the parent company has paid in excess of book value for the subsidiary's stock. This term is recommended rather than "Goodwill" to differentiate it from purchased goodwill which may appear on the books of the parent company. Similarly they recommend the term "Consolidation Discount" where the price paid for the controlling stock of a subsidiary is less than the book value of the net assets purchased. In view of the prevalent

desire of the accounting profession to standardize accounting language, the use of these terms, rather than the more familiar "Goodwill" and "Surplus arising from consolidation", will tend to confuse the reader of accounting reports. The authors' objection that this type of goodwill will be confused with the goodwill already existent upon the books of the parent company can readily be overcome by using the parenthetical explanation "Goodwill (including $...... goodwill arising from consolidation)." The authors submit examples of the use of their terminology in published financial reports.

Practitioners will find special interest in the chapter included in this text on Corporate Reorganization which is written by Harry L. Kuntzleman. This chapter represents, in a condensed fashion, an explanation of circumstances under which it may be necessary to reorganize a corporation, solutions of specific reorganization problems, and the law and procedures of reorganization together with an illustrative problem.

It appears to this reviewer that the authors have achieved their objectives. They have chosen their material well and have presented it in a complete and readable manner.

SHELDON FREEDMAN

c/o Eisner and Lubin,
New York, N. Y.

Audit Practice Case—Revised Edition (In Six Parts),

by Arthur W. Holmes and Francis E. Moore. RICHARD D. IRWIN, INC., Chicago, Ill., 1946. $5.00. (When purchased together with Holmes' text, the combined price is $9.00.)

The authors have prepared working material intended to help a student without any previous knowledge of or experience with auditing through a practical approach to the learning of the subject. They have divided their work into six parts, as follows:

Book I—Introduction and Instructions to Students. This apparently is intended to orient students in the procedures, material furnished and audit program.

Book II—Audit Report prepared by the accountants for the preceding year.

Book III—Books of Original Entry for the year to be reviewed and audited.

Book IV—Papers and Miscellaneous Data, available to the auditors for the year under review.

Book V—Ledgers for the year under review.

Book VI—Audit Working Papers for the previous year's audit.

The student is placed in the position of a member of the accountant's staff who is about to undertake an audit. He has available to him the history of what had been done in a prior year, and then he is thus able to become somewhat familiar with the client's business and problems. The current books and data are set forth sufficiently in detail to enable the student to apply to a practical problem the theoretical knowledge which he has acquired in his auditing classrooms.

The revised edition now made available should prove a valuable addition to the material now used in auditing classrooms. It should also be of material assistance to those entering the accounting profession as a source or reference book.

STANLEY B. TUNICK

The School of Business and
Civic Administration,
The City College of New York.

Outline of Internal Auditing,

by Lawrence R. Schmidt. STRATFORD HOUSE, INC., New York, 1946. 72 pages. Paper bound, $1.00; cloth bound, $2.00.

Internal auditing involves not only the verification of accounting records

but also the investigation of actual operating methods and results. It is performed by employees of the subject organization and, as is well known, is properly receiving renewed attention in the post-war reconversion period.

The purpose of this little book is to provide a handy reference manual for the use of those accountants who have newly entered the field of internal auditing. It is divided into two parts: the first presents a general discussion of internal auditing; the second, a specific internal audit program.

The manual should also be of considerable interest and help to independent public accountants in connection with their important task of appraising the adequacy of a company's system of internal check and control, as a basis for the determination of the extent of their examination.

New Developments in Accounting—1946,

(Papers presented at The Fifty-Ninth Annual Meeting of the American Institute of Accountants) New York, N. Y., AMERICAN INSTITUTE OF ACCOUNTANTS. 206 pages. $2.00.

The official text of the Proceedings of the 1946 annual meeting of the American Institute of Accountants has just come off the press. There are eight sections in the volume, as follows:

I. Deveopments in Accounting Procedure
II. Auditing Standards
III. Developments in Cost Accounting During the War as They Affect the Auditor
IV. Auditing Machine Kept Records
V. Special Problems of the Sole Practitioner and Moderate Sized Firm
VI. Accounting Education
VII. Addresses
VIII. Federal Taxation

There is a wealth of valuable, practical information packed into this book, which should be read by all students and practitioners.

The Control and Valuation of Inventories (Selected Papers),

compiled by Wyman P. Fiske and Raymond P. Marple. New York, N. Y., NATIONAL ASSOCIATION OF COST ACCOUNTANTS. viii + 408 pages. $3.00.

This compilation of papers, most of which have previously appeared in the N.A.C.A. Bulletins or in the Year Books, was originally published in 1941 as an aid to business concerns in the war emergency. It is equally important today, as a reference manual and advanced text on the subject, in helping to accomplish a speedy and effective transition to normal peace-time conditions.

The book covers the subject of Inventories thoroughly under four headings: Inventory Control (13 papers), Inventory Valuation (11 papers), Inventory Taking (3 papers), and Inventory Practice (2 papers). Two previously unpublished papers on inventory valuation (by Samuel J. Broad and Edward A. Kracke) and one on uniform inventory methods (by George V. Fortune) are included in the volume. The included material consists principally of case-studies of diversified industries reported by eminent, practical industrial accountants and educators.

An adequate index and a helpful bibliography (brought down to 1941, the publication date) complete this valuable work.

OFFICIAL DECISIONS *and* RELEASES

SECURITIES AND EXCHANGE COMMISSION

Philadelphia

ACCOUNTING SERIES
Release No. 56

The Securities and Exchange Commission today announced the issuance of a release in its Accounting Series discussing a problem that may face management investment companies in complying with the requirements of the recently revised Article 6 of Regulation S-X which governs the form and content of financial statements filed with the Commission by management investment companies. The release outlines certain procedures which may be followed in allocating past dividends so as to arrive at (1) the balance of undistributed net income (excluding gain or loss on investments); and (2) accumulated net realized gain or loss on investments. The release, prepared by William W. Werntz, Chief Accountant, follows:

"Inquiry has been made as to the procedure to be followed where a management investment company has not heretofore shown separately in its accounts (1) the balance of undistributed net income (excluding gain or loss on investments); and (2) accumulated net realized gain or loss on investments. Subdivision into these two categories is required of management investment companies by Rule 6-03-21 (a) (2) and (3) of the recently revised Article 6 of Regulation S-X, governing the form and content of financial statements filed by such companies. A principal problem in such segregation relates to dividends heretofore paid without any designation as between these two sources of income.

"Sec. 19 of the Investment Company Act of 1940 requires such segregation to be made in connection with dividends declared after the effective date of that Act. In connection with the promulgation on February 21, 1941 of Rule N-19-1 which implements Sec. 19, there was simultaneously published an interpretive letter[1] dealing with the treatment of past dividends.

"In my opinion, it would be appropriate to employ the methods and principles set forth in that letter in arriving at the segregated balances required by the new Rule 6-03-21(a)(2) and (3) of Regulation S-X. The pertinent portion of the letter reads as follows:

" 'In connection with Section 19 of the Investment Company Act and the recent Rule N-19-1 adopted pursuant to it, you have raised some questions of interpretation.

" 'Section 19 provides in effect that dividend payments made by a registered investment company must be accompanied by written statements adequately disclosing the source of the dividend if the dividend is paid wholly or partly from any source other than—

" '(1) such company's accumulated undistributed net income, determined in accordance with good accounting practice and not including profits or losses realized upon the sale of securities or other properties; or

" '(2) such company's net income so determined for the current or preceding fiscal year.

" 'Rule N-19-1, among other things, provides in effect for the segregation of certain designated sources of dividend payments for the purpose of disclosure.

" 'Your first inquiry, as I understand it, relates to the problem of ascertaining the presently available balances of the sources designated in Section 19 and Rule N-19-1. You point out that, prior to the time the Investment Company Act went into effect, an investment company may not have segregated its income and surplus in a way contemplated by that Section and the recently adopted rule; therefore, dividend payments in the past may not have been allocated according to the sources designated therein. You are concerned as to the method companies in this situation may use in determining *now* the sources against which past dividends are to be charged in order to determine the balances of "accumulated undistributed net income" and other sources available for the purposes of Section 19.

" 'Where, prior to November 1, 1940 (the effective date of the Investment Company Act) any legal allocation of dividend payments has been made on the books or by resolution of the board of directors, or in some other appropriate manner, to one of the sources set out in Rule N-19-1, in my opinion, such allocation need not be changed. As to past dividends not so allocated, it is my opinion that the following allocation should normally be followed: The total amount of such dividends accrued and declared in any

[1] The letter dated February 21, 1941, signed by David Schenker, then Director, addressed to Paul Bartholet, then Executive Director, National Committee of Investment Companies.

fiscal year should be charged first to the accumulated undistributed net income, if any, at the close of such year, and any excess should be charged to the accumulated net profits from the sale of securities or other properties, if any, at the close of such year, and any excess thereafter should be charged to paid-in surplus or other capital source. The determination of accumulated net profits from the sale of securities or other properties should be made in accordance with the company's financial accounts rather than its tax accounts.

"'Your second inquiry bears on the same problem. In examining the past to make the necessary determination of available balances now, transactions must be reviewed in the light of "good accounting practice," the standard set up in Section 19. Your problem is whether that standard is the good accounting practice of the present day or that of the date of any particular transaction. In my opinion, it is the latter.'"

ACCOUNTING SERIES
Release No. 57A

The Securities and Exchange Commission today announced a general revision of its requirements as to the form and content of financial statements filed by management investment companies other than those which are issuers of periodic payment plan certificates. The revised requirements are applicable to all financial statements filed by such companies under the Investment Company Act of 1940, the Securities Act of 1933 and the Securities Exchange Act of 1934. The action taken resulted in a complete restatement of Article 6 of Regulation S-X and in major changes in the related supplementary schedules contained in Rules 12-19, 12-20, 12-21 and 12-22 of Article 12 of Regulation S-X. In addition, as a result of the restatement of Article 6 certain related changes have been made in Rules 4-10 and 11-01 and in caption 1 (a) of Rule 11-02.

The Commission also made public a statement reviewing the development of the revised Article 6 and setting forth its conclusions as to certain of the problems with which the rules deal.

The amendments of Regulation S-X become effective on December 31, 1946, provided, that any financial statements included in a report required to be filed prior to March 15, 1947 need only comply with the provisions of Regulation S-X as in effect immediately prior to the adoption of these rules and, provided further, that rules prescribing the accounting treatment for any transaction or adjustment of the accounts shall be effective only as to transactions or adjustments of accounts for fiscal years commencing on or after December 31, 1946.

Copies of the new rules and of the Commission's statement* have been sent to all registered management investment companies and within 10 days will be sent to all persons who have requested any of the three following categories of material: (1) all rules, and amendments to all rules, adotped under any of the Acts administered by the Commission; and (2) accounting releases.

Since the amendments relate only to statements filed for management investment companies, copies of the new rules will not be distributed to the general mailing lists under the Securities Act of 1933 or the Securities Exchange Act of 1934. However, copies of the amendments may be obtained by any interested person upon request addressed to the Publications Unit, Securities and Exchange Commission, Philadelphia 3, Penna. The release numbers assigned thereto coincide with those on this release, except for the omission of the letter "A".

ACCOUNTING SERIES
Release No. 58

The Securities and Exchange Commission today announced the adoption of an amendment to Regulation S-X redesignating Rule 6-10 under Article 6A as Rule 6-10A.

The text of the Commission's action follows:

The Securities and Exchange Commission, acting pursuant to authority conferred upon it by the Securities Act of 1933, particularly Sections 7 and 19 (a) thereof, the Securities Exchange Act of 1934, particularly Sections 12, 13, 15 (d), and 23 (a) thereof, and the Investment Company Act of 1940, particularly Sections 8, 30, 31 (c) and 38 (a) thereof, and finding notice and public proceedings thereon and a 30-day postponement of the effective date hereof unnecessary because the amendment cannot adversely affect the rights of any person, hereby amends Regulation S-X by redesignating Rule 6-10 of Article 6A, as Rule 6-10A.

Effective December 31, 1946.

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* Issued as Accounting Series, Release No. 57.

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